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# MANAGING PROFITABLE CUSTOMER RETENTION – COLLABORATIVE EFFORT BETWEEN RETAILER AND SUPPLIER



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**ABSTRACT**
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# MANAGING PROFITABLE CUSTOMER RETENTION – COLLABORATIVE EFFORT BETWEEN RETAILER AND SUPPLIER


## The background and objectives of the study

The aim of this study was to examine how customer retention can be managed profitably and how collaboration between retailer and supplier can improve the process. Managing customer retention is difficult, especially in non-contractual setting like grocery retailing. Succeeding in the tough competition of grocery retail industry requires better management of customer retention. Resources must be allocated wisely to achieve maximum results. Data is already available, but a clear model of managing profitable customer retention is missing. There is an increasing urgency for marketing managers to understand how their actions affect the long term profitability of the customers and hence, the profitability of the company.

## Methodology

This study is qualitative in nature. The case research method was chosen as an appropriate method to find an answer to the research question. Data was obtained by semi-structured, face-to-face interviews. Both Finnish retailers and suppliers were interviewed: representatives from two major retail chains and five major suppliers. In addition, two experts on grocery retailing were interviewed in order to gather additional information. The sampling methods used in this study are judgmental sampling and snowball sampling. The interviewees were chosen based on the judgment and expertise of the researcher. In addition, experts were used to select the most appropriate interviewees. The interviews were tape-recorded and later transcribed. The analysis of the results was then made based on the written notes. The interviews were analyzed by comparing the results to the theoretical framework and to each other.

## Findings

The framework of profitable customer retention management suggests that profitable customer retention can be achieved by selecting target segments and retention strategies based on CLTV. Retention strategies affect determinants of retention and hence, customer retention. In addition, collaboration between retailer and supplier can improve the process. The way of managing profitable customer retention introduced in the theoretical section of this study is used to some extend in the case companies. Retailers are making more decisions based on customer profitability and CLTV than suppliers. However, there is a fast changes in the industry and fact based management of customer retention will be used more in the near future.


**Keywords**
Customer retention, profitability, customer lifetime value, partnership, fast moving consumer goods

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**Hanna Sivonen**

**TIIVISTELMÄ**
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# KANNATTAVAN ASIAKASPYSYVYYDEN HALLINTA KAUPAN JA TAVARANTOIMITTAJAN YHTEISTYÖNÄ


## Tutkimuksen tarkoitus

Tutkimuksen tarkoituksena oli selvittää kuinka asiakaspysyvyyttä voidaan hallita kannattavasti ja miten prosessia voidaan parantaa kaupan ja tavarantoimittajan yhteistyönä. Asiakaspysyvyyden hallitseminen on vaikeaa, erityisesti alalla, jossa asiakassuhde ei perustu sopimukseen. Menestyminen vahvasti kilpaillulla alalla vaatii hyvää asiakaspysyvyyden hallintaa. Resurssit täytyy jakaa viisaasti, jotta parhaat mahdolliset tulokset voidaan saavuttaa. Tietoa asiakkaista on saatavilla, mutta selkeä malli kannattavan asiakaspysyvyyden hallitsemiseksi puuttuu. Markkinoinnin parissa työskentelevien on ymmärrettävä, miten eri toimenpiteet vaikuttavat asiakkaiden pitkän aikavälin kannattavuuteen ja siten myös koko yrityksen kannattavuuteen.

## Aineisto ja tutkimusmenetelmät

Tämä tutkimus on kvalitatiivinen case tutkimus. Aineisto kerättiin teemahaastatteluilla. Sekä kaupan että tavarantoimittajien edustajia haastateltiin: kahdesta kaupan keskusliikkeestä haastateltiin yhteensä neljää henkilöä sekä tavarantoimittajista viittä henkilöä. Lisäksi haastateltiin kahta alan asiantuntijaa lisätiedon hankkimiseksi. Haastateltavat valittiin tutkijan oman asiantuntemuksen sekä haastateltavien vihjeiden mukaan eli kyseessä oli sekä harkinnanvarainen näyte että lumipallonäyte. Haastattelut nauhoitettiin ja kirjoitettiin myöhemmin auki. Analyysi tehtiin kirjallisten muistiinpanojen perusteella. Kaupan ja tavarantoimittajien haastattelujen tuloksia verrattiin toisiinsa ja lisäksi teoriaosassa muodostettuun viitekehykseen.

## Tutkimuksen tulokset

Kirjallisuuteen perustuvan viitekehyksen mukaan kannattava asiakaspysyvyys voidaan saavuttaa valitsemalla kohderyhmät ja asiakaspysyvyysstrategiat asiakkaan elinkaaren arvoon perustuen. Asiakaspysyvyysstrategioilla pyritään vaikuttamaan pysyvyyteen vaikuttaviin tekijöihin ja siten asiakaspysyvyyteen. Kaupan ja tavarantoimittajan välinen yhteistyö parantaa tämän prosessin tuloksia. Teoreettisessa osassa esitettyä viitekehysmallia käytetään jossain määrin case-yrityksissä. Kaupan edustajat tekevät enemmän päätöksiä perustuen asiakkaan elinkaaren arvoon kuin tavarantoimittajat. Ala kuitenkin muuttuu nopeasti ja tietoon perustuva asiakaspysyvyyden hallitseminen lisääntyy lähitulevaisuudessa.



**Avainsanat**
Asiakaspysyvyys, kannattavuus, asiakkaan elinkaaren arvo, partnerit, päivittäistavarakauppa

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# 1 INTRODUCTION

## 1.1 Background and Objectives of the Study

Reichheld and Sasser (1990) were the first ones to introduce the tangible benefits of customer retention. The statement that "reducing defections by 5% boosts profits 25% to 85%" has had a great impact on the practice of interactive marketing. They claim that higher retention rates lead to higher net present value of customers. This supports the well-known fact that acquiring new customers is more costly than keeping the existing ones.

However, as noted by Ryals (2005), customer retention is not important per se, but profitable retention is. Also other researchers (see e.g. Ahmad and Buttle 2002; Reinartz and Kumar 2002) have criticized Reichheld and Sasser's view as too simplistic. Relationship between loyalty and profitability is said to be much weaker: loyal customers are not necessary cheaper to serve, less price sensitive or particularly better word-of-mouth marketers. According to Reinartz and Kumar (2002) loyal customers might even be more price sensitive and more expensive to serve. Hence, customer retention must be carefully managed. By allocating resources to right segments and marketing actions, profitable customer retention can be achieved.

Finnish grocery retailing industry is changing rapidly at the moment. Major trends, such as development of technology, concentration of the industry, changing customer needs and internationalization, force retailers and suppliers to revaluate their way of doing business. (Finne and Kokkonen 2005, 21-22) Competition in grocery retail industry is fierce. Because of the decreasing margins in the field both retailers and suppliers are forced to operate more effectively. Price competition has become even fiercer since Lidl opened its first store in Finland 2002. In addition to competition inside the field, the consumer goods industry is losing share of wallet to other sectors, too.

ECR has affected the way of making business in Finnish grocery retailing since 1996. However, the emphasis has been mostly on supply chain management: logistics and cost reduction. In the future, the focus will shift to demand management and hence, to the customer. It is in both parties interest to serve the end customer in away that benefits both retailer and supplier and, in addition, the customer.

Managing customer retention is difficult, especially in non-contractual setting like grocery retailing. Metrics related to customer profitability, such as CLTV, are used more in contractual settings, especially in banking. As noted by Finne (2006), profitability and lifetime value of customers are not sufficiently researched in grocery retailing. Succeeding in the tough competition requires better management of customer retention. Resources must be allocated wisely to achieve maximum results. Data is already available, but a clear model of managing profitable customer retention is missing. There is an increasing urgency for marketing managers to understand how their actions affect the long term profitability of the customers. CRM can be made successful through the measurement and profitable management of customer relationships (Ryals 2005).

## 1.2 Research Question and Objectives of the Study

The main research question of this study is: *How can profitable customer retention be managed collaboratively by retailer and supplier?* The study aims at introducing the critical issues in collaborative customer retention management. In addition, the profitability aspect is taken into account.

The main research question is divided to the following subquestions:

- What is profitable customer retention in grocery retail sector?
- How can profitable customer retention be managed?
- How can the collaboration between retailer and supplier improve the process?

The objective of the study is to propose a framework for building profitable retention strategies collaboratively in retail sector. In order to achieve a holistic view of the subject, both retailer's and supplier's points of view are taken in to account.

## 1.3 Research Design

This study is based on existing marketing literature and empirical evidence from the interviews of two retail companies and five suppliers. The aim of the literature view is to identify different issues from the academic literature that are relevant when discussing the research problem at hand. A theoretical framework is developed, which builds upon literature concentrated on CRM, customer retention, customer profitability and lifetime value analysis as well as partnerships.

The empirical evidence is collected by interviewing representatives of Finnish grocery retailers and suppliers. The goal of the analysis is to find out how profitable customer retention is managed at the moment and how partnerships are utilized in the process. In addition, possible future views of the subject are covered. Finally, the empirical findings are compared to the theoretical framework and conclusions are introduced.

## 1.4 Scope and Limitations

The purpose of this study is to explore profitable customer retention in Finnish grocery retailing industry. Both retailers' and suppliers' points of view are taken into account. The focus is on one industry area only, which limits the extent to which the findings of the study can be generalized to other industries. In addition, the characteristics of Finnish markets affect the outcome of the study. Hence, the generalization of the results to other countries is limited.

This study concentrates on grocery retailing. According to the European Union the grocery retailing industry includes fast moving consumer goods sales, HoReCa (hotels, restaurants and catering) wholesales and alcohol sales (Päivittäistavarakauppa 2005). In this study, HoReCa and alcohol sales are limited out.

## 1.5 Structure of the Study

This study is divided into two main parts: theoretical framework based on literature and empirical study.

The next chapter starts building the theoretical framework by discussing relationship marketing, customer relationship management and customer equity briefly. After that, profitable customer retention is covered in detail.

The third chapter concentrates on the management of profitable customer retention. First, retention strategies are discussed. Second, customer lifetime value as basis for the management of customer retention is covered. Finally, the process of managing profitable customer retention is introduced.

The last theoretical chapter adds the collaboration between retailer and suppliers to the discussion. Characteristics and success factors of partnerships are discussed briefly. The cooperation in grocery retailing is covered by discussing ECR and by giving examples of possible ways to cooperate in managing profitable customer retention. In the end of the theoretical part, the framework based on the literature review is presented.

The methodology of the research is discussed in detail in chapter 5. Chapter 6 covers the findings of the empirical study. First, facts of the Finnish grocery retail industry are presented. Then, the findings from the interviews are summarized. Both retailers' and suppliers' opinions are covered. Finally, the findings of the empirical study are compared to the theoretical framework. The last chapter will summarize the whole study.

# 2 PROFITABLE CUSTOMER RETENTION IN GROCERY RETAILING

This Chapter concentrates on customer retention. First, relationship marketing and customer relationship management as background of profitable customer retention are discussed. Then, customer retention is covered in detail taking the special characteristics of grocery retailing into account. Finally, profitability and customer retention are tied together in the last Chapter.

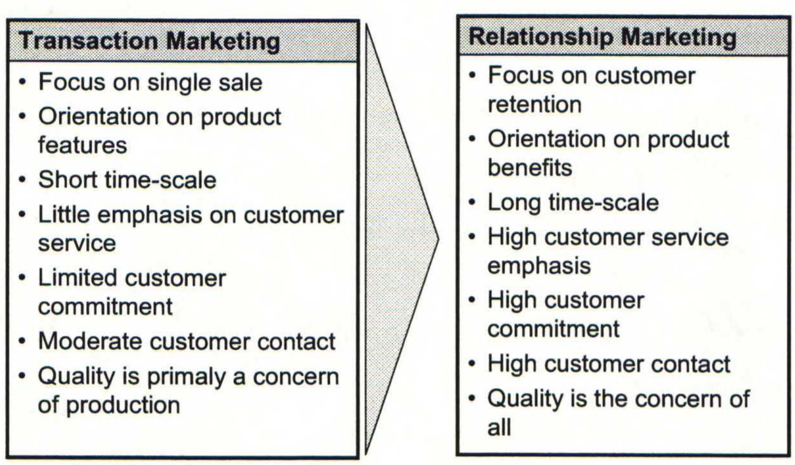
## 2.1 Relationship Marketing and CRM as Basis for Profitable Customer Retention

Relationship marketing and customer relationship management (CRM) provide background information about profitable customer retention and the management of it. First, relationship management is discussed and then the link between relationship management and CRM is covered. The second part of this Chapter concentrates on CRM.

*Relationship marketing*

Relationship marketing has been discussed extensively in recent literature; there has been a shift from product orientation to customer orientation and from transactional relationships to long-term relationships. Figure 2.1 describes the changes in marketing thinking.

**Figure 2.1: From Transactional marketing to Relationship Marketing**




Source: Modified from Christopher *et al.* 1991, 9

Marketing based on 4 Ps has been the dominating perspective until recently, but the current changes in the market, such as fragmented and maturing markets, increased competition, growing need for one-to-one marketing (Grönroos 1999), availability of data, the rise of services marketing and widespread changes in business processes (Grönroos 1996; Ryals and Knox 2001) drive and enable firms to adapt relationship marketing. Marketing is no longer seen as merely a function in a firm, but more as a management issue (Grönroos 1999). According to Grönroos (1996, 1999), relationship marketing is a new paradigm in marketing, not only a new model or tool. Relationship marketing is related to both in B-to-B and B-to-C markets.

Relationship marketing is based on the work of Berry (1983 ref. Zablah *et al.* 2004), the IMP group (see e.g. Ford *et al.* 1997) and Christopher *et al.* (1991). It has captured lot of attention since the 90's. However, there is no single definition of relationship marketing. Definitions vary in terms of broadness and scope, but most have common denominators. Grönroos (1997) defines relationship marketing as following:

> *Marketing from a relational perspective has been defined as the process of identifying and establishing, maintaining, enhancing, and when necessary terminating relationships with customers and other stakeholders, at a profit, so that the objectives of all parties involved are met, where this is done by a mutual giving and fulfilment of promises.*

There are two different perspectives to relationship marketing: the win-win approach, which emphasizes the benefits of both buyer and seller (e.g. Grönroos 1996) and the supplier side view (e.g. Reicheld and Sasser 1990), which underlines the positive effect of relationship marketing on company profitability. According to the first perspective relationship marketing has a dual objective of acquisition and retention of customers. The core of relationship marketing is to shift the emphasis from customer acquisition to customer retention and hence, improve a firm's long-term profitability. A firm must be able to create superior value to its customers and thus create value for itself. (Ravald and Grönroos 1996; Ryals and Payne 2001)

The supplier side view emphasizes possible cost reductions, such as lower sales and marketing costs, and return increases, such as increased sales of relationship marketing. Building relationships demands significant investments. Hence, profitability must go up as a consequence of relationship investments. (Szimigin and Bourne 1998)

In order to manage the ongoing relationship with the customer, a firm needs to act collaboratively between functions, departments and organizations. The whole chain of activities that create value to the customers (and hence, to the firm), has to managed as a one process. Only activities witch contribute to the profitability of a firm through customer value creation should be retained in the value chain. (Grönroos 1996) The collaboration between channel members will be covered in detail in Chapter 4.

Measuring returns of relationship marketing is not straightforward. Most researchers have focused on measuring customer lifetime value (see e.g. Ravald and Grönroos 1996; Gustafsson *et al.* 2005), customer and employee satisfaction (Reichheld 1993) and benefits of reduced supplier base and opportunity of create co-operative partnerships. Some researchers argue that returns of relationship marketing are not linked to customer satisfaction or customer loyalty (Lindgreen and Crawford 1999). Hence, new ways to measure returns on relationship marketing and customer retention must be investigated.

*The link between relationship marketing and CRM*

The terminology of relationship marketing is somewhat ambiguous. Both relationship marketing and CRM have many different meanings depending on the perspective. In addition, there is no clear difference between relationship marketing and CRM; they are even used as synonyms. There is a need to define these terms so that they are seen as distinct phenomena.

Ryals and Payne (2001) introduce a hierarchy of terms in their article. According to them, relationship marketing can be seen as a philosophical basis of CRM. It is associated with high-level strategy, whilst CRM is more tactical term. CRM is the way to implement relationship marketing. It enables firms to organize themselves around their customers by integrating marketing, sales and service functions trough providing customer data. The key principles of both CRM and relationship marketing are gathering and analyzing customer data, developing marketing strategies to personalize the relationship and thus, maximizing the value of customer portfolio (Ryals and Knox 2001; Ryals and Payne 2001). These definitions are in line with the previously presented definition of relationship marketing and the upcoming definition of CRM.

The core of all CRM and relationship marketing perspectives is the cooperative and collaborative relationship between a firm and its customers (Parvatiyar and Sheth 2001), and the interactive communication between them. However, CRM is not solely focused on close, collaborative relationship. Since the object of CRM is to developing and maintaining profit maximizing portfolio, customer relationships are likely to include both transactional and relational exchange relationships. Thus, CRM is concerned on building an ideal mix of customers while relationship marketing is focused only on building and sustaining close relationships. (Zablah *et al.* 2004)

*CRM*

There is a lack of consensus between marketing practitioners about the definition of CRM and hence, the term has been used in several different ways. Zablah *et al.* (2004) identified five different perspectives in their research:

1. CRM as a Process
2. CRM as a Strategy
3. CMR as a Philosophy
4. CRM as Capability
5. CRM as a Technology

The process perspective emphasizes the evolution of buyer-seller relationships over time (Srivastava *et al.* 1999). The strategy perspective concentrates on customer lifetime value as determinant of investments in relationships. According to philosophy perception, focus should be on relationship building and maintenance in order to achieve greater customer retention and hence, customer profitability. If CRM is seen as capability, the determinant for success is continuous adaptation of firm's behavior towards individual customers. (Zablah *et al.* 2004) The last perspective emphasizes the role of technology in profitable and long-term customer retention (e.g. Ryals and Knox 2001).

All of the five definitions about CRM contribute to the understanding of the complex, multidimensional phenomenon. However, they lack a common view. Zablah *et al.* have built a conceptualization, which is mostly based on macro process perspective, but other perspectives have had their effect on it, too. They define CRM as following:

> *CRM is an ongoing process that involves the development and leveraging of market intelligence for the purpose of building and maintaining a profit-maximizing portfolio of customer relationships.*

Since CRM is seen as a business process, it must have inputs and outputs. The strategic perspective provides evidence about the possible output of CRM. The purpose of CRM is to maximize customer lifetime value (e.g. Parvatiyar and Sheth 2001) and thus, the indented output of CRM process is profit-maximizing portfolio of customer relationships (Zablah *et al.* 2004). An important point is that CRM is based on dual value creation i.e. emphasis is on creating value both to the customer and to the firm (Boulding *et al.* 2005).

A relationship orientation, customer retention and creating superior customer value are bases of CRM. A firm should be able to manage relationship with individual customers. The main objective is to retain the selected, high profitability customers in the long run. (Ryals and Knox 2001; Ryals and Payne 2001) Not all customers are equally desirable, since their profitability varies. Customers have different needs and preferences which should be taken into account. In addition, the relationship with the customer is constantly changing when the customer reaches different lifecycle stages and his attitudes and perceptions change. (Bell *et al.* 2005) CRM is needed to manage the complicated and changing relationships.

As noted by Parvatiyar and Sheth (2001) to be able to increase profitability, marketing productivity must be improved. This is achieved by increasing marketing efficiency and by enhancing marketing effectiveness. These objectives can be reached with CRM. The cooperative and collaborative processes reduce transaction costs and overall development costs. Proactive customer business development and building partnering relationships lead to superior joint value creation.

## 2.2 Customer Retention in Grocery Retail Sector

Customer retention is discussed in this Chapter. First, customer equity theory and the role of customer retention in it are presented. Second, the role of customer retention in managing customer portfolio is defined. Then, the determinants of customer retention are introduced. The final Chapter concentrates on the special characteristics of customer retention in retail sector.

Defining customer retention is not simple. There is confusion between the definitions of retention and loyalty. Customer retention and customer loyalty can be used as synonyms (e.g. Reichheld 1996; Reinartz and Kumar 2002) However, according to Blattberg *et al.* (2001, 69) customer retention is not the same as customer loyalty. A customer can be retained even is he is not loyal and a loyal customer may leave the company. Also, loyalty and repeat purchases are seen as different phenomena. Genuine loyalty is associated with the intention to buy rather than just repeat purchasing (Bell *et al.* 2005). Huddleston *et al.* (2004) state that repeat purchase is not stable over time, because it can be influenced by for instance competitor actions. Customer can defined as spuriously loyal if he has high repeat purchase behaviour but low relative attitude. Here, customer loyalty is seen as distinct phenomena. This study concentrates to customer retention.

The definition of customer retention depends on the length of purchase cycles. Blattberg *et al.* (2001, 68) introduces two definitions for customer retention. The definition for products or services with short purchase cycles is:

> *The customer continues to purchase the product or service over a specified time period.*

The definition for products or services with long purchase cycles is:

> *The customer indicates the intention to purchase the product or service at the next purchase occasion.*

In retail context, the first definition is relevant and thus used in this study.

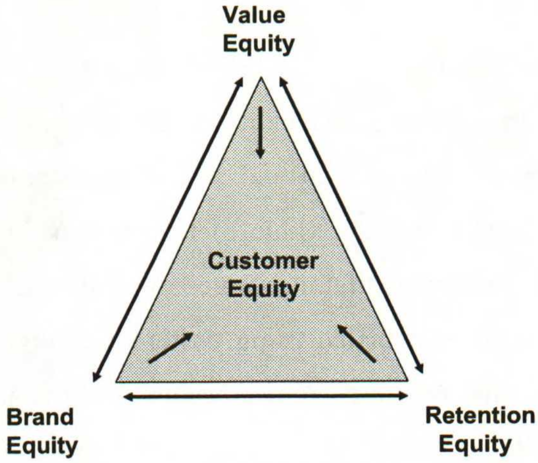
### 2.2.1 Customer Retention as Part of Customer Equity-theory

According to Blattberg *et al.* (2001, 3), "customer equity is a dynamic, integrative marketing system that uses financial valuation techniques and data about customers to optimize the acquisition of, retention of and selling of additional products to a firm's customers" and hence maximizes the value of the customer relationships to the firm. Customer equity is the discounted lifetime values of all the firm's customers. The long-term value of a firm can be calculated using customer equity. Thus, customer and the strategies that add the value of the customer become the main consideration of a firm. (Lemon *et al.* 2001, Rust *et al.* 2000, 4)

The main reasons for companies to start to use the customer equity approach are the ability to do so because of new technology and the necessity to do so since the market environment requires it. Customer equity management is possible because of the amount of customer data available nowadays. There is also a vast amount of analyzing tools to enable firms to utilize the customer information. The market is becoming more competitive and traditional marketing tools are not enough to attract and keep the customers. (Blattberg *et al.* 2001, 7-10, 21)

The three drivers of customer equity are value equity, brand equity and retention equity (Figure 2.2.). Value equity is based on customer's objective evaluation of the firm's offering. This perception is influenced mainly by quality, price and convenience. Brand equity is build through brand awareness, attitude toward the brand and corporate ethics. It is the customer's subjective view of the firm and its products. (Lemon *et al.* 2001; Rust *et al.* 2000, 8, 55-57)

**Figure 2.2: The Drivers of Customer Equity**




Source: Rust *et al.* 1999, 57.

A great brand and a great product are not enough to keep the customers. A satisfied customer may not be loyal. Thus, a firm needs to find a way to glue the customer to the firm. Hence, retention equity is needed to increase the tendency of the customer to stick with the firm, above and beyond his subjective assessments of the brand. The retention equity is the customer's view of the strength of the relationship between the customer and the firm. The significance of relationship equity depends on the importance of loyalty program to the customers, the role of customer community, the ability to establish learning relationships with customers and the perceived switching cost. The overall customer equity can be enhanced by increasing the value of one or more of the drivers. (Lemon *et al.* 2001; Rust *et al.* 2000, 8, 55-57)

According to Blattberg *et al.* (2001, 13) managing customer equity in order to maximize the value of the customer base is based on four cornerstones: 1) Managing the customer life cycle, 2) Exploiting the power of databases, 3) Quantifying customer value precisely, and 4) Optimizing the mix of customer acquisition, retention and add-on selling. Acquisition, retention and add-on selling are the core strategies in customer equity management. These strategies shouldn't be applied in isolation but the links between them should be analyzed and investment decisions made based on those analyses (Blattberg *et al.* 2001, 31).

As noted by Hogan *et al.* (2002) customer equity is aggregate measure that reflects the overall value of the customer base. If customer management strategies (e.g. retention strategies) are planned, individual or segment level measures, such as customer lifetime value, must be used. These are discussed in Chapter 3.

### 2.2.2 Customer Retention as Part of Customer Portfolio Management: The Links between Acquisition, Retention and Defection

The background of customer retention is in the customer portfolio theory. The portfolio theory was first used in financial investment decision making in order to reduce risk (Markowitz 1952). The application of portfolio theory to customers is relatively new phenomenon. Customer portfolio is used to allocate recourses in a way that maximizes profitability and minimizes risks. It deals with different customer life cycle phases: creating new relationships, maintaining and developing relationships and discarding relationships. (Zolkiewski and Turnbull 2002) Next, the links between acquisition and retention, and retention and defection are examined.

There is a link between acquisition and retention. Hence, the customer acquisition and retention strategies should be aligned. If a firm acquires wrong kinds of customers, it will be difficult to maintain them or maintaining them might be unprofitable. (Blattberg *et al.* 2001, 81) For example, aggressive price reductions might bring lots of new customers, but they are probably not profitable and / or loyal. Acquiring wrong kind of customers can also affect the existing customer base negatively, especially in services since customers interact with each other.

Reinartz *et al.* (2005) created a framework for maximizing customer profitability through balancing acquisition and retention resources. They found out that suboptimal allocation of retention expenditures has more significant effect on long-term profitability than suboptimal acquisition expenditures. Other findings were that even if expenditures to acquisition or retention become less efficient when investing more than the optimal, it is better to overspend than underspend.

Defection and retention can be seen as two sides of a coin: retention can be increased by decreasing defection. This study concentrates on managing customer retention, witch implicitly assumes that defection is managed at the same time. It is important to note that managing defection includes efforts to retain good customers and get rid of wrong customers. Thus, defection is not always a bad thing: a firm is more successful without unprofitable customers. However, it is difficult to actually fire customers especially in non-contractual setting. Hence, defection of unprofitable customers can be managed by stopping to invest in these relationships.

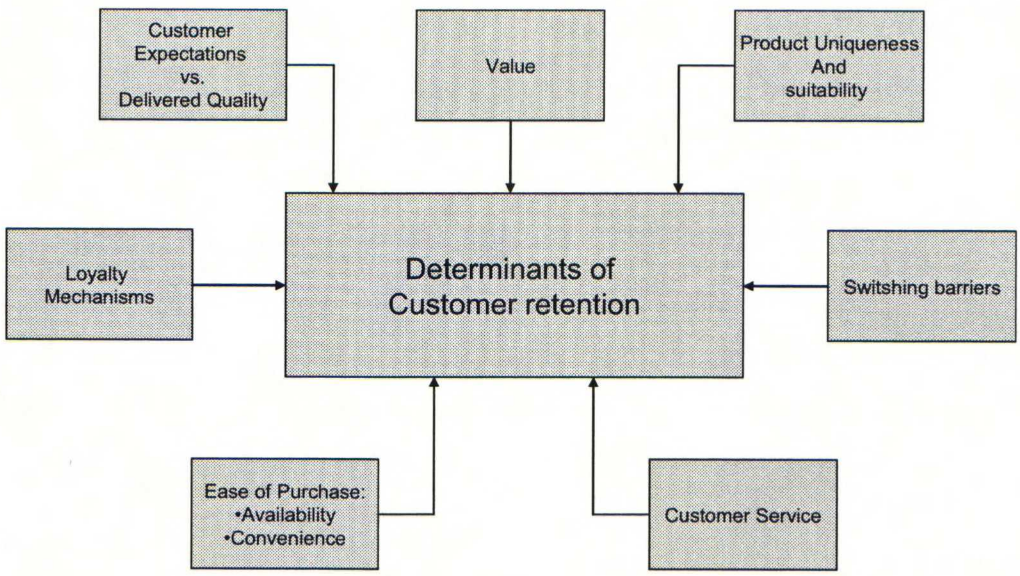
Defection can be partial or total. Total defection is typical to contractual settings whereas partial defection is more common in non-contractual settings. Partial defection, being a special characteristic of grocery retailing, will be covered in more detail in Chapter 2.2.4.

### 2.2.3 Determinants of Customer Retention

Customer retention is influenced by firm, customer and competitor actions (Reinartz *et al.* 2005). A firm can plan its marketing activities in order to increase retention, but is can also fail to do this and drive customers away. Customers may, or may not be willing to engage long relationships with a firm (Sheth and Parvatiyar 1995). Situational triggers (e.g. demographic changes in the family, changes in job situations, and changes in the economic situations) and / or reactional triggers (e.g. a decline in performance before purchase or during purchase or during consumption) can make customers defect (Gustafsson *et al.* 2005). The actions of competitors can result in loosing or winning customer. This Chapter discusses the determinants of retention from the retail point of view.

Customer satisfaction is assumed to be the main driver of customer retention (see e.g. Ravald and Grönroos 1996; Gustafsson *et al.* 2005). Blattberg *et al.* (2001, 71-75) introduces a different model of the key factors affecting retention rates (Figure 2.3.). They argue that concentrating on customer satisfaction will result in satisfaction trap: customer satisfaction is increased, but benefits, such as increased sales, profitability and customer loyalty, are not achieved. Thus, other determinants must be taken into account. In addition, as noted by Reinartz and Kumar (2000), high satisfaction levels do not guarantee increased customer retention in highly competitive markets with low switching cost, such as grocery retailing.

**Figure 2.3: The Determinants of Customer Retention**




Source: Modified from Blattberg *et al.* 2001, 72.

Determinants of retention differ across industries. Since the scope of this study is in grocery retailing, the model of retention determinants is evaluated from that point of view. According to Landsverk (2003) the seven key elements of a retail brand are the following:

1. *The physical store* (store design: furniture, shelves, light and colors, layout)
2. *Service* (people, their skills, the innovation culture, friendliness, the atmosphere, service standards)
3. *Fresh food products* (bread, meat, meal solutions and fruits / vegetables)
4. *Own label products* (range, quality, price)
5. *Communication* (promotional activities, mass communication, database marketing)
6. *Price positioning and quality standards* in different product areas
7. *Access attributes* (distance of the store, opening hours, traffic, parking etc.)

These elements affect the choice of the store and hence, also the decision to remain as a customer (Landsverk 2003). Next, the model of Blattberg *et al.* (2001) is discussed in detail taking these elements into account.

Retention is affected by customer expectations and the ability of the firm to deliver quality that matches the expectations. Customer expectations are important, because customers evaluate products or services through expectations, not on product's own merits. If expectation levels are raised too much in the beginning, customers will disappoint and defect. Hence, creating high expectations but not delivering the quality will result in low retention rates. (Blattberg *et al.* 2001, 72) The physical store, price positioning and communication create expectations to grocery customers. For example, the physical appearance of hard discounters creates expectations of low prices. On the other hand, the price positioning of a premium store creates expectations of quality and service. If these expectations are not met, the customer will probably defect.

Retention can be enhanced by creating superior value to the customers. Value is defined as quality divided by price (Blattberg *et al.* 2001, 73). A broader view of customer perceived value is the ratio between perceived benefits (e.g. product attributes, quality and value added services) and perceived sacrifices (e.g. price, time and inconvenience of shopping):

*Customer perceived value = Perceived benefits / Perceived sacrifices.*

This model does not take relationship value into account. According to Ravald and Grönroos (1996) the value of having a relationship might influence the total value a great deal. A good relationship enables customer to view the firm as a whole, which decreases the impact of occasional inferior performances. The relationship value consists of safety, credibility, security and continuity, which increases trust between a firm and its customers and hence support customer loyalty. The relationship value decreases perceived sacrifices since shopping is made easier and more efficient when the customer knows the store well. This is especially important in retailing since most people do not enjoy grocery shopping (Huddleston *et al.* 2004). For a customer relationship value means also reduction of choices and hence easier selection of product or service (Sheth and Parvatiyar 1995). As noted by Landsverk (2003), the meaning of relationship value varies between store types: hard discounters do not have strong relationships with customers whereas small specialty store might benefit a lot from relationship value.

Product uniqueness and suitability drive customer retention because the less substitutable the product or service is, the higher the retention rate. If customers have access to many identical product or service offerings, the competition increases and the probability to attract and keep the customer decreases (Blattberg *et al.* 2001, 73). Grocery retailing is facing this problem: there is a lot of competition and the offerings of the grocery retailers are quite similar. The elements of store brand create possibilities to differentiate the offering. For instance, very high service standards or unusual store design can be used as a differentiating factor.

Loyalty mechanisms, such as frequent shopper cards, link usage and rewards and hence, generate retention. These are especially important when competing products or services are almost identical. Thus, grocery retailers are among those who find this determinant important. (Blattberg *et al.* 2001, 73) Loyalty cards are commonly used in grocery retailing. However, the effect of them is not clear. Many of the card-holders have several loyalty cards, so it might be that they do not create any real competitive advantage. (Mägi 2003; Verhoef 2003) Loyalty programs are discussed in more detail in Chapter 3.

According to Blattberg *et al.* (2001, 73-74) Lack of availability and / or inconvenience of shopping reduce customer retention. Customers are not willing to travel long distances to do their grocery shopping (Raijas 1997, 34). It is unlikely that they would buy frequently from grocery store that is not located near their home or job. Insufficient opening hours can also be a factor that creates inconvenience. Grocery shopping is usually not something that customers enjoy. Hence, reducing inconvenience can be used to increase retention. This can be done by improving service, access attributes and / or the appearance of the store.

According to some studies (e.g. Bell *et al.* 2005) customer service is a very important factor of retention. Both technical (i.e. quality of the service output) and functional (i.e. process and interaction quality) quality (Grönroos 1983) are positively associated with customers' attitudes towards the firm and hence with customer retention (Bell *et al.* 2005). Huddleston *et al.* (2004) found several service quality- related issues in their study of food store loyalty. Friendly service was among the characteristics of favorite store. However, the participants mentioned many dislikes relating to service quality, such as rudeness of sale personnel, long checkout lines, out of stock, lack of employees and department hours (deli) are too short.

Increased switching barriers enhance customer retention. Some firms (e.g. banks) have high switching costs and some (e.g. grocery stores) have low (Roos *et al.* 2004). Switching cost can be financial (e.g. lost discounts), procedural (e.g. competitor evaluation) or relational (e. g. loss of personal contact) (Burnham *et al.* 2003). Exit barriers can be created for example by rewarding from frequent usage of the product or service (Blattberg *et al.* 2001, 74) or providing personal service to customers.

Table 2.1 illustrates the importance of the seven determinants. The most important reason for selecting a grocery store is proximity, which indicates that ease of purchase is important to the customers. Preferred customer benefits influence store choice. Thus, the loyalty mechanism and service are valued by the customers. In addition, product related attributes, such as range and freshness and price-quality ratio i.e. value are important to the customers.

**Table 2.1: Main Reasons for Selecting the Primary Grocery store**

**Main reasons for selecting the most frequently used consumer goods shop (2-3 most important reasons)**

| | % of households chose |
|---|---|
| Proximity | 54 |
| Product range | 37 |
| Preferred customer benefits | 35 |
| Price-quality ratio | 34 |
| Ease/speed of purchases | 30 |
| Price level | 26 |
| Product freshness | 18 |
| Opening hours | 14 |
| Service-minded staff | 14 |
| Parking facilities | 11 |
| Service counters | 8 |

Source: A. C. Nielsen Finland Oy Talouspaneeli

### 2.2.4 Special Features of Customer Retention in Grocery Retail Sector

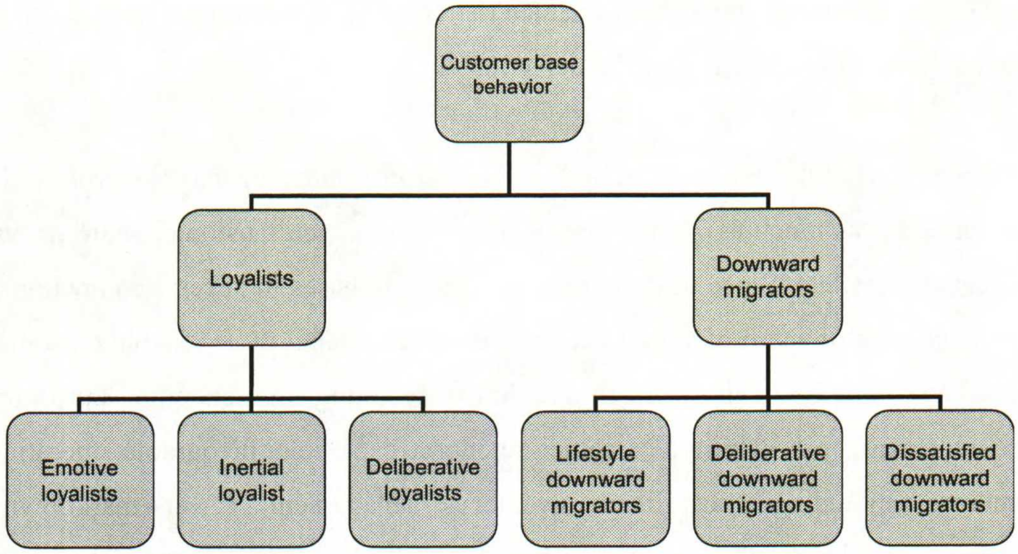
This Chapter discusses the special characteristics of customer retention in retail sector. Particular attention is given to partial defection.

According to Huddleston *et al.* (2004) most grocery shoppers have a preferred store, where they use as much as 78 per cent of their food budget. Customer share of wallet is important to retailers. Since customer divide their purchases to several competing stores, the management of share of wallet becomes essential. (Mägi 2003) Stable customer base brings many benefits to the firm. In addition to retaining high spending customers and hence increasing profitability, customer retention can yield favourable operation cost advantages, including streamlined inventory management, fewer markdowns and simplified capacity forecasting. Other benefits include increased spending over time, reduced store-wide price discounts (price promotions can be targeted to valuable customers) and word-of-mouth marketing. (Huddleston *et al.* 2004)

Coyles and Gokey (2005) divide customers in to two groups based on their behaviour (Figure 2.4.). Loyalists are those who stay with the company and downward migrators are those who are defecting in some extent. These groups are then divided into three subgroups according to their attitudes, needs and satisfaction. Emotive loyalists feel strongly that the chosen brand is best for them and hence rarely reassess their purchase decisions. They are the most loyal ones. Inertial customers reassess purchase decisions infrequently, but are not loyal in the same sense than emotive loyalists. Inertial loyalists are uninvolved; they do not consider switching worth the effort. Deliberators frequently reassess their purchase decisions according to rational criteria such as price and store location. They can be retained until something better comes to the market.

Downward migrators are also divided into three subgroups. Lifestyle migrators spend less because of change in their lifestyle, such as moving and starting a family, and thus change in their needs. Deliberators, as mentioned earlier, reassess their purchase decisions frequently and hence choose to cut down their spending when current service provider is not the best one according to their rational criteria. Dissatisfied customers usually migrate because of a single bad experience such as rude sales clerk or other service failure. (Coyles and Gokey 2005)

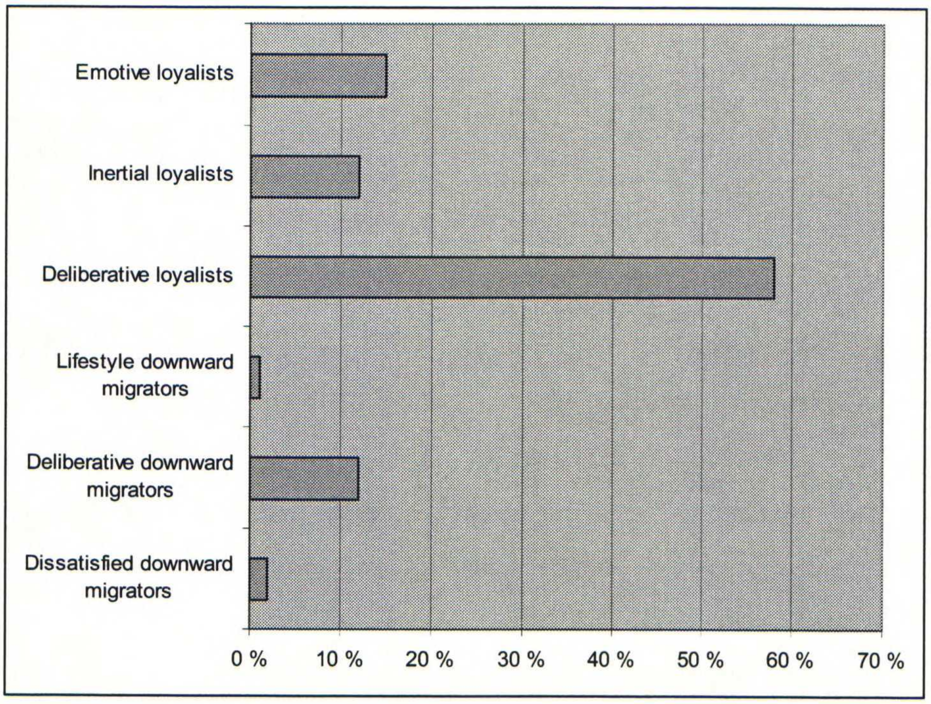
**Figure 2.4: Dimensions of Loyalty**




Source: Modified from Coyles and Gokey 2005

Every industry has different loyalty profiles. Figure 2.5 shows the importance of deliberators in grocery retailing: 58 per cent of loyalists and 12 per cent of downward migrators are deliberators. (Coyles and Gokey 2005) Huddleston *et al.* (2004) raise a question if loyal food store customers even exist. It might be that they are only repeat customers. Their research shows that there is no strong relationship between customers and their preferred food store. Even if customers usually spend most of their food budget in one store, they might not be loyal. Most of the customer they interviewed said that they would be willing to switch to another shop if new, better competitor entered the market. These findings support the findings of Coyles and Gokey (2005).

**Figure 2.5: Loyalty Profiles of Grocery Retailer's Customers**




Source: Modified from Coyles and Gokey 2005

Since the existence on genuine food store loyalty is not certain and the emotional bond is missing between the customers and food store, this study will concentrate on retention. Retained customers can be loyal (in an emotional way) or not, but they stay with the firm. The perspective of this study is more behaviour based that intention based.

*Partial defection*

There are two kinds of defection: total and partial. Total defection is simple to define: customers leave the company. This usually easy to observe since customers have to act to leave the company: e.g. customers close their accounts in banks or change their mobile phone operator. Partial defection is more difficult to define, since it is not clear when defection takes place. Buckinx and Van den Poel (2005) define partial defection as change in the buying behavior. Loyal customers are those whose frequency of purchases is above average and ratio of the standard deviation of the interpurchase time to the mean of interpurchase time is below average (i.e. customer buys regularly). If one of these conditions is not fulfilled anymore, the customer has become partial defector. Ultimately, partial defection might lead to total defection. For instance, a customer begins to do part of his shopping in another shop and eventually, defect totally.

Sometimes customers communicate that they have or are planning to defect. In some settings, the customer has to act to stop consuming the product or service (e.g. subscribing a magazine or belonging to book club). Unfortunately this is not the case in most business settings since customers can defect without informing the firm. This makes it difficult to manage customer retention because defected customers are hard to identify. (Blattberg *et al.* 2001, 69)

Total defection is not the main concern of retail companies. It is more common that the customers only defect partially. Hence, the management of downward migration is essential since more money is lost through partial defection than through total defection. Coyles and Gokey (2005) found out in their study that managing migration can be as much as ten times more valuable than managing total defection only.

A firm has a chance to prevent defection, if it manages migration. Downward migrators can be identified and a firm can plan how to keep them. (Coyles and Gokey 2005; Buckinx and Van den Poel 2005) Managing migration includes also upward migration i.e. increased buying behavior (Coyles and Gokey 2005). By encouraging cross- and up-selling, revenues can be enhanced.

## 2.3 Customer Retention as Basis of Profitability

As noted by Ryals (2005), customer retention is not important per se, but profitable retention is. This Chapter will discuss the link between customer retention and profitability. The first Chapter discusses the link between customer relationships and shareholder value and the second Chapter concentrates on retention and profitability.

### 2.3.1 Customer Relationships as Market Assets

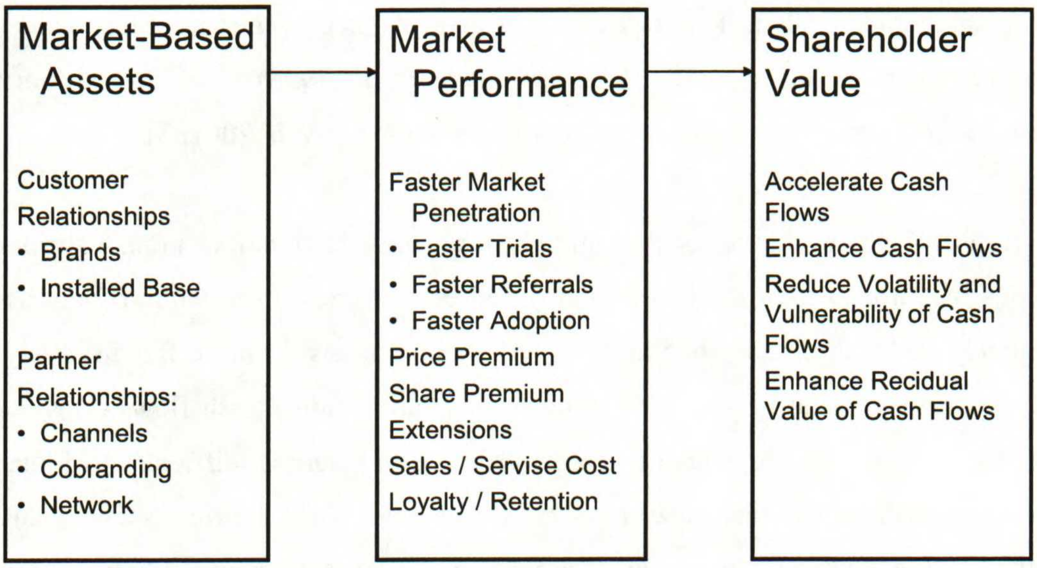
The popularity of shareholder value-based management has led to increasing demand for corporate valuation methods (Bauer & Hammerschmidt 2005). Unfortunately, the basic problem of marketing has been the lack of clear objectives and measures (Doyle 2000). However, decision making becomes easier when it can be done based on measures and facts, not purely opinions (Blattberg 2001, 10). Identifying, measuring and communicating the financial value created by marketing activities have been seen as an extremely difficult or even impossible task. However, the main target of marketing is to create shareholder value. This has led to a growing need for shareholder value-based measures in marketing (Doyle 2000; Srivastava *et al.* 1998) since the customer is a financial asset just like any other asset in a firm (Blattberg *et al.* 2001, 3).

Barney (1991) states that an asset is any physical, organizational, or human attribute that enables the firm to improve its efficiency and effectiveness. The value of any assets is ultimately realized, directly or indirectly. Marketing assets do not differ from any other asset since their value lie in contributing to generating future cash flows (Doyle 2000). The value of an asset depends of its convertibleness, rareness, difficulty to imitate and lack of substitutes (Srivastava *et al.* 1998). Customer asset metrics, such as customer lifetime value and customer equity, are closely related to commonly used financial measures, such as return on investment (ROI) and economic value added (EVA) (Bell *et al.* 2002).

According to Doyle (2000), the traditional measures of marketing's contribution to shareholder value have been sales volume and increased market share. In addition, brand awareness, consumer attitudes, repeat buying, and customer satisfaction levels have been used to evaluate and justify marketing strategies. The problem with these metrics is that they have only a weak link or no link at all to profitability. Marketing has suffered from lack of credibility in the boardroom because other functions seem to make more measurable contributions to the bottom-line. Marketing actions are traditionally considered as expenditures. However, as noted by (Hogan *et al.* 2002), customer asset management perspective suggests that the focus of a firm should be in customers and their ability to produce cash flow over time.

Customer relationships are linked to shareholder value through market performance (Figure 2.6.). Srivastava *et al.* 1999 (see also Stahl *et al.* 2003) introduces ways to add shareholder value through customer relationship management process. Both customers and partners help to create value. Partnerships are discussed in more detail in Chapter 4.

**Figure 2.6: Link between Market Based Assets and Shareholder Value**




Source: Srivastava *et al.* 1998

Customer relationships can help to accelerate and enhance cash flows. Cash flows can be accelerated by developing products faster, reducing time for market acceptance (i.e. market penetration cycle time) and minimizing customer solution development cycle time. The level of cash flows is enhanced when higher revenues are generated and / or costs are reduced. Supporting high margins with branded products and superior service, cross-selling, acquiring customers (growing installed base) and refining the quality of customer base ultimately leads to enhanced cash flows. Cash flows can also be enhanced through cost reductions in customer acquisition, relationship building, customer retention, sales and service. In addition to these, lowering working and fixed capital requirements will enhance cash flows. These can be achieved by developing close relationships between suppliers and customers. (Srivastava *et al.* 1998, Stahl *et al.* 2003)

In addition to increasing cash flows, it is important to reduce the risk related to the cash flows. Risk can be cut down by reducing vulnerability and volatility of cash flows from the customers, which leads to a lower cost of capital or discount rate. More stable and predictable cash flows have higher net present value and consequently increase shareholder value.

The vulnerability of cash flows is reduced when customer base is less susceptible to competitive activities. Risk can be affected by managing customer satisfaction, loyalty and retention. This will result in less volatile cash flows since the cost of retaining customers is likely to be more predictable than the cost of acquiring new ones. (Srivastava *et al.* 1998; Srivastava *et al.* 1999) As noted by Stahl *et al.* (2003) the risk can be spread across customers by managing the customer portfolio: decreasing dependence on single customer will reduce cash flow volatility when well-balanced customer portfolio is created.

The ultimate goal of a firm should be maximizing customer asset value. In order to do this, the firm needs to measure the asset value and use this information to make decisions about investments in acquisition, retention and cross-selling. (Blattberg 2001, 4) Measures, such as predicted customer duration and lifecycle cash flows, should be used to decide how to allocate resources to improve long-term profits and customer loyalty (Reichheld 1996, 34). These are discussed in more detail in Chapter 3.

### 2.3.2 The Link between Customer Retention and Profitability

Reichheld and Sasser (1990) were the first ones to introduce the tangible benefits of customer retention. The statement that "reducing defections by 5% boosts profits 25% to 85%" has had a great impact on the practice of interactive marketing. They claim that higher retention rates lead to higher net present value of customers. This supports the well-known fact that acquiring new customers is more costly than keeping the existing ones (researchers suggest it to be from 2 to 20 times more expensive).

Other researchers (see e.g. Ahmad and Buttle 2002; Reinartz and Kumar 2002) have criticized this view as too simplistic. They claim that relationship between loyalty and profitability is much weaker: loyal customers are not necessary cheaper to serve, less price sensitive or particularly better word-of-mouth marketers. According to Reinartz and Kumar (2002) loyal customers might even be more price sensitive and more expensive to serve. They expect tangible benefits from their loyal behavior and demand more service and better discounts.

The profitability of customer retention is based on the following assumptions:

1. Some customers are more profitable than others.
2. In some cases, the profitability of a customer can be increased by lowering cost to serve and / or by increasing cross- and up-selling.
3. The return on investment is higher for retention strategies than for acquisition strategies. ROI can be improved when resource allocations are done based on customer lifetime value.
4. Increased customer retention leads to less risky cash flows.
5. By increasing the proportion of profitable customers, the profitability of the customer portfolio, and hence the profitability of the whole company, can be increased.

The profitability of the customers varies. Some customers buy high margin products and are easy to serve. On the other extreme, customers can be very costly to serve, and they buy only low margin products. Hence, the profitability of customer can vary from negative to highly positive. For some customers, the profitability can be increased by lowering costs and increasing revenue. Customers can be directed to lower cost channels, such as Internet. Cross- and up-selling can be used to sell more and more profitable products. However, not all customers can become profitable. The company must recognize which customers can be upgraded and allocate marketing resources to these customers.

Ryals (2005) found out in her study about customer retention in financial services industry that customer retention is not important per se, but the retention of profitable customers is. Thus, investments in retention strategies are unlikely to success if customer lifetime value is not taken into account from the beginning. Only profitable customers should be targeted. The amount of money used for the marketing actions should depend on the expected profitability of the customers. When resource allocation decisions are made based on customer lifetime value, marketing actions will have better return on investment (ROI). In addition, as noted by Buckinx and Van den Poel (2005), ROI is usually higher for retention- than acquisition strategies.

By increasing the amount of profitable customers (and decreasing the amount of unprofitable customers), the profitability of the customer portfolio can be improved. This can be done by retaining profitable customers, and in some cases, “firing” loss-making customers. As noted before, since the cost of retaining customers is likely to be more predictable than the cost of acquiring new customers, cash flows will be less volatile (Srivastava *et al.* 1998; Srivastava *et al.* 1999). Hence, the riskiness of customer portfolio is decreased.

In conclusion, retention brings profitability by accelerated and enhanced cash flows as well as less risky cash flows. The profitability of some customers can be increased over time. When the profitable customers are kept, the profitability of the whole customer portfolio is improved. The profitability is also increased by improving the return on investment of marketing actions.

Building profitable customer retention is not easy. Many companies have failed to create real value for the customer and for the firm. The measurement of the outcomes is not straightforward which adds the probability to fail. The rest of this study will concentrate on the process of managing profitable customer retention and the possibility to benefit from the collaboration between retailers and suppliers. Customer lifetime value as a tool of managing profitable customer retention will be introduced.

# 3 MANAGING PROFITABLE CUSTOMER RETENTION

Managing customer retention in order to maximize profitability is not an easy task. It requires analyzing the customer base, allocating resources appropriately and managing the costs of implementation. In order to successfully manage retention strategies, right measures are needed to help planning and evaluating the results.

The new way of managing customer retention will lead to changes in customer management strategy. The study of Ryals (2005) shows several changes in the customer strategy of the case company: customer acquisition, retention and divestment became more selective, and resource allocation, service levels, pricing and product strategy were changed.

A process of managing profitable customer retention is introduced in this Chapter. First, common retention strategies are introduced and second, the process is discussed in detail.

## 3.1 Retention Strategies

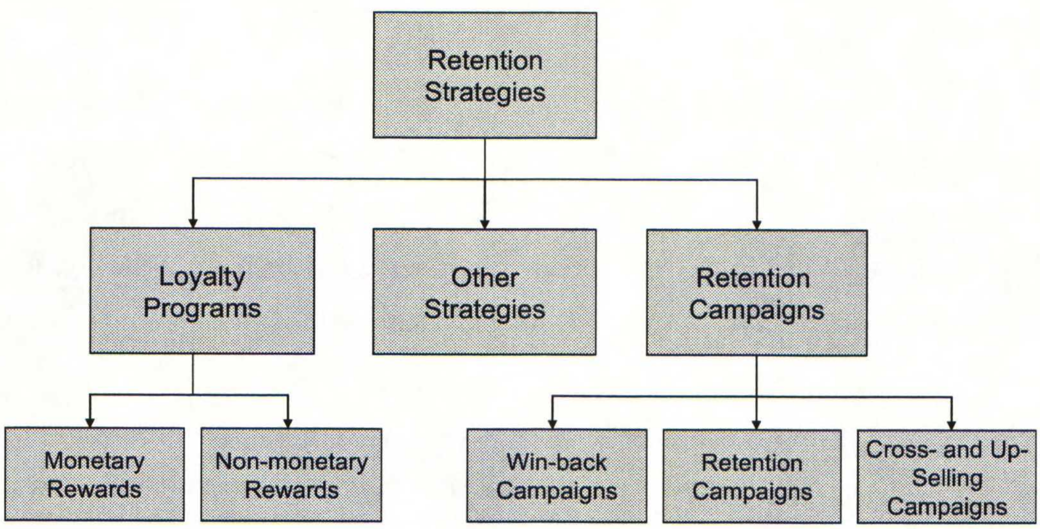
Retention strategies should aim to nurture long-term relationships with customers (Xevelonakis 2005). Customer information is the key element of developing retention strategies. The customer database has become a core asset to all companies (van Raaij 2005). Through utilizing the knowledge about the customers, different segments' needs and wants can be met and value created to both the firm and the customer. (Xevelonakis 2005)

Retention programs are one way to tie customers to the firm. According to Rust *et al.* (2000, 96) retention programs should aim to three objectives: 1) Maximize the likelihood of future purchases, 2) Maximize the monetary value of the purchases, and 3) Minimize the likelihood that customer defects totally or partially. The first two objectives are more of add-on selling (i.e. cross- and up-selling) objectives, whilst the last one is purely retention objective. All of these will be taken into account in the following Chapters.

Retention strategies should affect the determinants of customer retention and thus increase retention. The seven determinants of retention were introduced in Chapter 2: loyalty mechanisms, value, customer expectations vs. delivered quality, product uniqueness and suitability, switching barriers, customer service and ease of purchase. Chapter 3.1.1 covers loyalty programs which are included in loyalty mechanisms. Switching barriers are also discussed in this Chapter. Retention campaigns affect the value that the customer and the firm are getting. This is discussed in Chapter 3.1.2. Other determinants are covered in Chapter 3.1.3.

Figure 3.1 illustrates different retention strategies as they are discussed in the following Chapters. Loyalty programs include programs with monetary and non-monetary rewards. Retention campaigns are divided into three categories: win-back, retention and cross- and up-selling. Other strategies are specified later.

**Figure 3.1: Retention Strategies**



### 3.1.1 Loyalty Programs

"Loyalty programs are structured marketing efforts which reward, and therefore encourage, loyal behavior" (Sharp and Sharp 1997). The goal of these programs is to provide increased satisfaction and value to the profitable segments and hence increase the retention rate among the best customers (Bolton *et al.* 2000).

There are several studies that indicate a positive effect of loyalty programs to customer retention (e.g. Rust *et al.* 2000; Verhoef 2003). Because the rewards of loyalty programs depend on prior behavior, they can serve as a switching barrier for the customer. If the amount of rewards depend on the length of the relationship, customers are less likely to switch since it would take time to receive the same kind of rewards from other firms. (Verhoef 2003) According to Lewis (2004) loyalty programs that base rewards on cumulative purchasing are explicitly trying to enhance customer retention. By encouraging repeat buying, retention rates are improved and. Psychological studies show that rewards can be very motivating (Latham and Locke 1991) and hence, customers stay with the firm if they are rewarded.

Nevertheless, many researchers have questioned the effect of loyalty programs to customer retention (e.g. Sharp and Sharp 1997; Bolton *et al.* 2000). A survey made in 1997 (Szmigin and Bourne 1998) showed that while 20 % of card-holders said that owning the loyalty card had changed their shopping behavior, only 3 % said that they now shop in one store only. Almost 80 % had not changed their behavior or become more loyal.

Mägi (2003) argues that the findings that show change in customer behavior after joining the loyalty program might partly be affected by the amount of customers who join the program because they already are frequent shoppers. This also explains the number of multiple-card holders: customers who already shop in different chains will join all the available loyalty programs since they want to benefit from all of them instead of sticking with one chain.

Loyalty programs might be the answer for increasing customer retention, but they have other benefits, too. Loyalty programs provide a means to capture transaction and customer information (Kumar and Shah 2004). This information can be used to learn about the customers and hence, delivering better value (Szmigin and Bourne 1998). In fact, as noted by Ziliani and Bellini (2004), cards do not create loyalty or retention, they actually measure it. Most of the rewards serve as incentive to use the card and thus, provide information for the retailer. Customers usually give information about themselves when they apply for loyalty card. This information can be then used for customer retention management. Later, information about customer behavior based on transaction data can be used for adjusting retention strategies.

The effect of loyalty programs can be significantly enhanced by improving the quality of the program. Kumar and Shah (2004) introduce a new dominant logic for loyalty programs in their article. Table 3.1 summarizes the differences between earlier programs and the advanced programs. The most fundamental change in managing loyalty will be the shift from aggregate level strategies to customer level strategies. Future programs are not based on usage or spend; instead, more sophisticated means of accounting are used as base for rewarding (e.g. profitability). Rewards will be more personalized and aiming to specific goal (e.g. introducing new product categories). To be able to provide personalized rewards, partners are used to widen the reward range. Reward mechanism will no longer be based on past behavior. Instead, proactive rewards are offered to influence future behavior and purchase motivation.

**Table 3.1: Evolving Dominant Logic for Loyalty Programs**

| *No.* | *Dimension* | *Earlier loyalty programs: program centric* | *Evolving loyalty programs: customer centric* |
|---|---|---|---|
| 1 | Operationalization level | Aggregate level | Customer level |
| 2 | Program type | Standardized, based on usage or spend | Customized, based on type of usage or type of spend |
| 3 | Rewarding Scheme | Standard and uniform aimed at repeat purchase | Personalized and relevant, aimed at influencing specific behavioral change or attitudinal gratification |
| 4 | Reward options | Minimal | Multiple (usually made possible through partners and alliances) |
| 5 | Reward mechanism | Reactive | Reactive + proactive |
| 6 | Reward type | Tangible | Tangible + experiental |
| 7 | Program objective | Build market share, increase revenues, build behavioral loyalty throug repeat purchase or usage | Link loyalty to profitability, influence behavioral loyalty, cultivate attitudinal loyalty |
| 8 | Metrics used | RFM, PVC, SOW* | CLTV |
| 9 | Technology and analytics usage | Minimal | Extensive |

* RFM: recency, frequency and monetary value; PVC: past customer value; SOW: share of wallet.

Source: Kumar and Shah, 2004

With the help of extensive technology and analytics usage, loyalty programs can be managed to link profitability and retention. Forward looking metrics, such as customer lifetime value, can be used to proactively manage retention and profitability at the same time. (Kumar and Shah 2004) These new loyalty programs might be better to enhance retention since they are more meaningful to the customer. Further, by taking profitability into account, these programs also create value to the company.

Loyalty programs can offer monetary and non-monetary value to the customer. Frequency programs based on monetary rewards are the most common way to reward customers. However, non-monetary rewards might be a better way to make the customers stay with the firm (Rust *et al.* 2000, 102). Companies are starting to become more innovative in creating intangible and experiential rewards (Kumar and Shah 2004). Monetary and non-monetary rewards are discussed next.

*Monetary rewards*

Frequency programs are based on rewarding customers from their purchases. Customers earn some kind of promotional currency (e.g. points or miles) from their purchases. Earned currency can then be used for rewards or future purchases. According to Rust *et al.* (2000, 101) frequency programs are just a way give special discounts.

Frequency programs are widespread in Finnish groceries. Every chain has their own program that attempt to grow the share of wallet and increase retention. Many of the customers are multiple-card holders, which leads to situation where competitive loyalty programs cancel each other out. Thus, a firm has to take the cardholders' "card portfolios" into account when planning and evaluating the effectiveness of their loyalty program. (Mägi 2003) The amount of multiple-card holders has led to changed balance of power between customers and retailers. Customers get most of the benefits from every loyalty program, but retailers do not get loyal customers or complete database of customer behavior. (Szmigin and Bourne 1998)

To make the frequency program work, several criteria must be met: 1) A customer must earn points frequently enough to accumulate sufficient rewards, 2) The rewards must be meaningful and 'worth saving for', and 3) The margins of the products or services of the firm must be high enough to make the program profitable (Rust *et al.* 2000, 101).

Unfortunately, these criteria are not especially well met in grocery retailing, which has led to running down inefficient programs. In addition, even if the loyalty program is successful, the benefits might be lost since the overall costs of the industry increase if similar competitive programs emerge and cut out the competitive advantage (Gupta and Lehmann 2005, 127).

It is difficult to make frequent buyer programs profitable in the grocery retail sector since: 1) The grocery retail business is faced with short-term pressures which makes it difficult to introduce programs that requires patience from the customers, and 2) programs are difficult to fund to create significant value to the customers because of the weak margins of the industry. (Rust *et al.* 2000, 101) Szmigin and Bourne (1998) argue that the relationship link between retailers and their customers developed through loyalty cards is weak. Most customers do not consider the rewards meaningful and worth saving for. In addition, most frequency programs are almost identical and do not offer any extra value to the customer. This leads to multiple-card ownership and spurious loyalty.

As discussed, frequency-based monetary rewards in retailing have many problems. Non-monetary rewards, which are discussed next, might be the way to improve loyalty programs in grocery retail sector.

*Non-monetary rewards*

Non-monetary or soft rewards include special recognition and treatment programs, affinity and emotional connection programs, customer community programs and knowledge-building programs (Rust *et al.* 2000, 100).Special recognition and treatment programs offer rewards based on customers' purchase behavior. Examples of rewards include customers being recognized by name; own, faster lines for best customers and personal service. The best customers usually value these benefits more than extra offers or discounts. (Rust *et al.* 2000, 102-103) Although cash is usually seen as universally desirable, non-monetary rewards can create greater perceived value to the customers than they cost to the firm (Gupta and Lehmann 2005, 128).

Affinity groups are groups of customers with shared interests. The key aspect of affinity is that the firm's offering becomes an integral part of the customer and the customer feels similarity with the brand. Hence, the firm can increase customers' switching costs because switching to competitor would lead to the feeling of "loss of self". (Rust *et al.* 2000, 103-104) Not all firms can offer such products or services that create strong interest or emotional link. The use of affinity groups might be extremely difficult in grocery retailing, since fast moving consumer goods do not invoke strong feelings. However, some firms have been creative and tapped into the customer community and the customers' emotional connection.

As noted by Rust *et al.* (2000, 105) customer community programs are closely related to affinity programs. In affinity program, the customer feels connection to the offering of the firm while in community program he is connected to other customers. A customer community can be created if customers are convinced that they will benefit from the connection to the other customers. Customers' perceived cost of switching can be increased by creating the community. If customer leaves the firm, he must also leave the community. There are many examples of community programs in grocery retailing. Mothers of small children are especially popular target of customer community programs. Many retailers and suppliers (e.g. Tesco, Heinz, Waldbaum's, Nordiconad etc.) have baby clubs.

Emotional connection and particular interest in the product are not always required when non-monetary rewards are offered. Knowledge-building programs help a firm to build retention by creating trust. Every time a customer interacts with a firm, both learn something about each other. (Rust *et al.* 2000, 107) A customer in a grocery store learns for instance where certain items are located and when the store is busy, which makes shopping easier. The retailer learns about customer behavior and purchasing patterns. This creates structural bonds between the firm and the customer. The firm can tailor its offering to fit the needs of the customer. Thus, it becomes more costly to switch to the competitor since recreating trust and learning from each other takes time. (Rust *et al.* 2000, 108)

The time frame of loyalty programs is long. Retention campaigns, on the other hand, are more short-term oriented. They are discussed in the next Chapter.

### 3.1.2 Retention Campaigns

Repeat buying and hence, retention can be encouraged through a range of short-term discounts (Lewis 2004). However, as noted by Sharp and Sharp (1997), retention promotions are different than regular sales promotions. Retention promotions are more defensive (i.e. aiming to keep the customers rather than attracting new ones) oriented and the time frame is usually longer.

There are three kinds of retention campaigns: win-back, retention and cross- and up-selling. Win-back campaigns are targeted to customers who no longer produce turnover for the firm. The objective is to get these customers back. Retention campaigns are targeted to current, profitable customers. The goal is to keep these customers from defecting partially or totally. (Xevelonakis 2005)

Cross- and up-selling campaigns concentrate on increasing the profitability of existing customers by selling more or more profitable products and services (Xevelonakis 2005). According to Blattberg *et al.* (2001, 75) add-on selling (i.e. cross- and up-selling) is positively related to customer retention. When customer buys many products from the firm, it increases the relationships between the firm and the customer. This affects retention in a positive way. As noted by Ryals (2003b), multiple product holding is linked to customer retention.

Add-on selling will be successful only if the firm is able to analyze the customer base and find out which customers would respond to the campaigns (Blattberg *et al.* 2001, 97). Add-on selling impacts positive both customer retention and customer profitability. The firm has to choose whether to enhance relationship duration or to improve customer profitability and then target those customers who will help to reach that goal (Blattberg *et al.* 2001, 119). Xevelonakis (2005) notes that a firm can use combinations of the different types of campaigns. For instance cross- and up-selling campaigns usually influence also retention.

According to Reichheld (1996, 82), it is important to notice that retention campaigns are not the same thing than regular price reduction and coupons. They are not effective in creating retention since they influence customers who are mostly interested in price discounts. These customers are not profitable and probably willing to switch to competitor's offering if better discounts are available. If price discounts are used, the firm has to carefully analyze which customers can be retained by using this kind of campaign.

### 3.1.3 Other Ways to Increase Retention

Formal programs and campaigns are not the only way to improve retention rates. Retaining customers in retail sector has a lot to do with details. Too many out-of-stocks and long queues will drive the customers away; no matter how great retention programs and campaigns are offered to them. Hence, meeting the expectations in the shopping situation is a necessary antecedent of customer retention; loyalty programs and campaigns only work if the company can create value to the customer and deliver the expected quality.

Since customers do not usually enjoy grocery shopping, retention can be increased by making shopping easier. The proximity of the store makes shopping both easier and faster. Hence, the location decisions affect customer retention. Traffic in the area and parking facilities must also be taken into account. The opening hours affect the ease of shopping. Because lifestyles of the customer vary greatly nowadays, long opening hours are essential.

Retention can be increased by improving product or service reliability, improving product or service quality without increasing price and developing new products or services. (Blattberg *et al.* 2001, 157-158) As discussed in Chapter 2. one of the reasons why customers select their primary grocery store is product range. Adding more and better products will enhance retention. Service is also important to many customers. Personal service can even become a switching barrier since the customers do not want to leave the personal relationship with personnel.

Xevelonakis (2005) introduces number of ways to increase customer retention. Products, services, processes, and channels must be tailored to meet needs and wants of the customer. Customer information can be used to find out the needs of the best segments. The offering of the store can then be tailored to fit to needs of the customers.

According to Sheth and Parvatiyar (1995) customer retention can also be affected through other customers. Family, friends and other social groups influence the choice of products and services and the relationship building between the customer and the firm. If the whole family enjoys shopping in a certain grocery store, they will probably remain as customers.

Retention can be enhanced by improving customer service and avoiding creating dissatisfied customers. Make life easier for your customers, make it fun or pleasurable to do business with you, customize, deliver what you promise and personalize your products and services could be common rules to increase retention. If a retailer does not wish to compete solely based on price, identifying segments with distinct preferences in terms of service, value and convenience, and then exceeding the expectations of these customers can be used to build retention in the highly competitive environment.

## 3.2 Customer Lifetime Value as Basis for Managing Profitable Customer Retention

In order to manage profitable customer retention, profitable customers must be recognized. By adding the proportion of profitable customers in the customer portfolio, the profitability of the whole company is improved.

There are many ways to choose the right customers to be retained. For example customer lifetime value, advanced relative scale method (recency, frequency, monetary value), past customer value / customer profitability and share of wallet can be used to choose the highest-value customers. However, studies (e.g. Kumar and Shah 2004; Kumar and Petersen 2005; Reinartz and Kumar 2000) have showed that customer lifetime value outperforms the other methods. In this Chapter, customer lifetime value is discussed. First, the choice of customer lifetime value as a tool is justified and customer lifetime value is defined. Second, the data requirements are covered. Finally, ways to calculate customer lifetime value are introduced.

### 3.2.1 The Definition of Customer Lifetime Value

The terms used about customer lifetime value are not consistent. There are many abbreviations from customer lifetime value: LTV (e.g. Rosset *et al.* 2003), CLV (e.g. Gupta and Lehmann 2005; Pfeifer *et al.* 2005)) and CLTV (e.g. Ryals and Knox 2005). In this study, CLTV is used. Customer lifetime value which contains risk analysis is called economic value (EV) by some researchers (e.g. Ryals and Knox 2005). In this study CLTV is considered to be a model that takes also risk into account.

Customer lifetime value (CLTV) as a simplest is defined as the present value of all current and future profits of a customer. This model takes many aspects into account: it includes future profits, it takes the time value of the money into account and it recognizes that not all the customers are going to stay with the company (i.e. it takes risk into account). (Gupta and Lehmann 2005, 15) As noted by Ryals and Knox (2005) CLTV illustrates what the current customers are worth to the firm now, based on the predicted future profits.

Even if CLTV is future-orientated model, historical data is not totally meaningless. Customers' prior behavior is usually a good predictor of the future behavior. A well-established model is needed to predict the buying behavior. The challenge is to build a model that describes future customer behavior accurately enough, but would not require detailed, complex data about the history. (Fader *et al.* 2005)

Customer lifetime value is often measured without taking the risks of the relationship into account. This leads to over optimistic valuations of the customer base. (Gupta and Lehmann 2005; Ryals and Knox 2005) In order to create shareholder value, customer relationships should be measured and managed for value rather than profit. Hence, both risks and returns of the relationship must be taken into account. (Ryals and Knox 2005)

The popularity of customer lifetime value is based on the fact that it is the only forward-looking method; others are purely considered about the past behavior of the customers (Kumar and Shah 2004). Basing marketing strategies on historic or current customer profitability does not create long term value, since it can be misleading and lead to suboptimal strategies (Ryals 2002). Advanced relative scale method has an additional disadvantage: it focuses on revenue rather than costs which hinders real profitability analysis. CLTV is also the only method that is consistent with the customer-centric paradigm of marketing. CLTV, being forward-looking metric, enables firm to be pro-active in marketing. (Kumar and Shah 2004) Hence, customer lifetime value is the method used as a decision tool in this study.

### 3.2.2 Data Requirements for CLTV

To be able to estimate CLTV, detailed data about the customers must be available (Gupta and Lehmann 2005, 18-19). As noted by Kumar and Petersen (2005), the data should have three characteristics. First, the data must be at the customer level. Second, detailed transaction information is needed to analyze profitability. Third, data should be available at least from the last two to three years, but the more data the better results.

According to Ryals (2002), the reliability of CLTV calculation depends on the quality of the data and the ability to predict customers' future behavior. Modeling customer lifetime value is relatively straightforward in contractual setting (e.g. subscribing a magazine) since the birth of customer relationship, purchase activity and defection are easily identified. The situation is far more complicated in non-contractual setting. (Reinartz and Kumar 2000) Data warehouses are needed to store the data and data mining tools can be used for predictions. Grocery retailers have been pioneers in identifying purchase patterns and developing loyalty programs.

*Revenues and costs included in CLTV*

There are many ways to estimate customer lifetime value. The mathematical model and its calculation depends on many factors, such as is the firm operating in contractual of non-contractual setting. (Rosset *et al.* 2003) Researchers have not agreed which costs and revenues should be included in the calculation of CLTV.

*Revenue.* Bauer and Hammerschmidt (2005) divide the revenue from the customer into four sub-categories: "autonomous" revenue and up-selling (these together represent straight selling), cross-selling revenue and reference value (i.e. contribution margins resulting from referral activities of current customers). The first three are direct monetary transaction values while the last one is indirect. Hence, the last revenue source is more difficult to estimate. In the model introduced later in this study, reference (or word-of-mouth) value is not included.

*Costs.* It is not clear whether to include acquisition costs to the CLTV model. Pfeifer *et al.* (2005) suggest that acquisition costs are only included when calculating CLTV for a prospect. They call this model prospect lifetime value (PLV). This information is needed when making decisions about new customer acquisition. A company should prospect only if PLV is showing positive cash flows in the future. However, acquisition costs should not be included in CLTV calculation since current customers would be burdened with acquisition spending that was wasted on prospects who did not respond. Other researchers (e.g. Bauer and Hammerschmidt 2005) agree that acquisition cost should be treated as sunk costs.

Fixed costs (i.e. costs which do not vary respect to the number of customers) are not included in CLTV calculations because they are not customer specific (Bauer and Hammerschmidt 2005). Variable costs associated with producing and providing products and services are included in CLTV (Pfeifer *et al.* 2005). According to Ryals (2005) costs should not be allocated proportional to sales volume or value since not all the customers require same amount of resources even if they buy the same amount of products. Activity-based costing should be used to properly allocate the costs to serve.

Bauer and Hammerschmidt (2005) propose that marketing and sales costs should be included in CLTV calculations. Marketing costs include all promotional and advertising expenditures that are designed to increase retention rate, but exclude costs that are specifically oriented towards acquisition. These might be difficult to differentiate, since for instance image advertising enhances both retention and acquisition. Sales costs include production costs and customer service costs, such as handling, warehousing and shipping.

The data requirements discussed show the complexity of collecting, analyzing and implementing the concept of CLTV. Customer lifetime value metrics work perfectly well in theory and very complicated analysis can be used. However, these highly sophisticated models are probably not going to be beneficial to firms at this time. More simplistic methods must be implemented first to show the big picture and after they prove their power, more complicated methods can be introduced. (Gupta and Lehmann 2005, 19-20)

Since it is impossible to calculate precise CLTV value and it is unlikely that companies would implement the most sophisticated models of calculation, the next Chapter will concentrate on the most simplistic ways of implementing the CLTV concept.

### 3.2.3 Calculating CLTV

Even if the most sophisticated and detailed models are used, the estimation of CLTV is not precise. Estimations require many assumptions and subjective approximations about profit and defection patterns. Profits can be calculated in various ways as discussed earlier. The decision maker can choose different ways to define which costs and revenues are allocated and what way to the customers. This leads to imprecise and approximate estimates of CLTV. However, this does not mean that calculating CLTV is a waste of time: it is better to have good estimate to support the decisions than to go along without any information. (Gupta and Lehmann 2005, 20-24)

Several different models for calculating CLTV are presented in the literature. However, none of these models is generally accepted as the superior approach (Bauer and Hammerschmidt 2005). The Table 3.2 presents some of these models. Despite the differences, all the models seem to have common parameters: margin (or net margin), discount rate and retention / defection rate. Nevertheless, the way to define these parameters might vary. One of the simplest approaches is the model introduced by Gupta and Lehmann (2005). It is a basic model that can be used as basis for CLTV calculation. Hence, it is the model used in this study. Next, it will be covered in detail.

**Table 3.2: Models for Calculating Customer Lifetime Value**

| *Source* | *Mathematical Model* | *Explanation* |
|---|---|---|
| Bauer and Hammerschmidt 2005 | $CLTV_{i0} = \sum_{t=o}^{T} r_i^t \frac{(R_{ti} - C_{ti})}{(1+d)^t}$ | R= future revenues<br>C = future costs<br>t, T = time<br>r = retention rate<br>d = discount rate |
| Gupta and Lehmann 2005, 24 | $CLTV = m\left(\frac{r}{1+i-r}\right)$ | m = margin or profit per customer per period<br>r = retention rate (%)<br>i = discount rate (%) |
| Hogan *et al.* 2002 | $CLTV_i = m_{1i} /(k_1 + d)$ | m = net margin<br>k = discount rate<br>d = defection rate |
| Rosset *et al.* 2003 | $CLTV = \int_0^\infty S(t)v(t)D(t)dt$ | S = survival function<br>v = customer's value over time<br>D = discounting factor<br>t = time |
| Ryals 2005 | $CLTV = \sum_{t=1}^{n} \frac{(CR_n - CC_n)}{(1+i)^n}$ | CR = future lifetime revenue<br>CC = future lifetime costs<br>i = discount rate |

The method Gupta and Lehmann (2005, 24) use is highly simplified. It assumes that (1) profit margins remain constant over time, (2) retention rate for the customer remains the same over time, and (3) CLTV is estimated over an infinite horizon. The profit of contribution margin from a customer is the revenues minus the direct costs generated from the customer. Some researchers (e.g. Reichheld 1996) argue that the profit from a customer grows as time goes by. However, some researchers state that it actually decreases and some that it stays the same over time. Hence, constant margins are assumed in the model. (Gupta and Lehmann 2005, 27-28)

The retention rate of a customer does not change over time i.e. customers do not necessarily become more loyal as the time goes by. Each cohort consists of customers who are more or less loyal. The less loyal ones tend to leave early as the loyalists stay with the company. Hence, the retention rate for individual customer or segment stays the same as assumed in this model. (Gupta and Lehmann 2005, 31)

Time frame of five to seven years is usually used in CLTV calculations. However, it is not necessary to arbitrarily specify the duration of the customer lifetime, because the retention rate and the time value of the money bring the CLTV close to zero over time. With retention rate of 80%, the average length of customer relationship is five years. In addition, infinite time frame allows changes in the relationship length; a customer can stay less or more than five years. (Gupta and Lehmann 2005, 32-33)

As seen in Table 3.2, the mathematical model is the following:

$$CLTV = m\left(\frac{r}{1+i-r}\right)$$

where

m = margin or profit from a customer or segment per period (e.g. per year)

r = retention rate for customer or segment –for example 0,8 or 80%

i = discount rate for customer or segment –for example 0,12 or 12%.

Thus, customer lifetime value equals margin (m) multiplied by *margin multiple* i.e. retention rate (r) divided by (1+discount rate (i)-retention rate (r)) (Gupta and Lehmann 2005, 25). The model can be used for both customer and segment level (Ryals 2005). Sometimes it is feasible to make resource allocation decisions based on the profitability of individual customers (Bell *et al.* 2002) (e.g. in B-to-B markets), but in retailing it is more appropriate to rely on segment-based analysis. Calculating CLTV might be easy in contractual settings but in non-contractual settings, such as grocery retailing, the calculation is more challenging. Working on segment level makes it easier to estimate CLTV because each individual customer's future value does not have to be estimated separately. Instead, average estimate of the segment can be used. (Rosset *et al.* 2003) If segment based calculations are used, the customers must be divided into segments based on their profitability and riskiness. This can be done by finding similar purchasing patterns and then segmenting based on that information.

First, the margin must be estimated for each segment. The estimation is based on the previous purchase behavior. Second, the retention rate is assessed. Retention rates vary usually between 60 and 90 percent (Gupta and Lehmann 2005, 25). The retention rates for each segment (or customer) must be estimated separately.

Discount rate, usually the weighted average cost of capital (Hogan *et al.* 2002), reflects the riskiness of the segment (Ryals 2002). According to Gupta and Lehmann (2005, 25) discount rate depends on the riskiness of the company's business and its debt-equity structure and it typically vary in the range of 8-16%. They suggest that the same discount rate is used for every segment.

However, different customer segments might vary in terms of riskiness. Variety of risk factors, such as reduced share of wallet, reduced size of wallet and increased cost to serve, must be considered (Hogan *et al.* 2002). Ryals (2002) suggests that every segment has its own discount rate reflecting its riskiness. Profits from customers with average risk are discounted with the discount rate of the company. More risky customers are discounted with bigger discount rate. For example 50 % riskier segment is discounted with 1,5 times the discount rate of the company. Vice versa, less risky customers are discounted with smaller discount rate.

The margin multiple varies usually between 1 and 4,5 (see Table 3.3). The multiple is low for high-risk segments with low retention rate i.e. risk and customer defection decreases the future profits from the customers. Vice versa, low risk segments with high retention rate have high margin multiple and hence, the future profits are increased. (Gupta and Lehmann 2005, 25-26)

**Table 3.3: Margin Multiple**

| Retention Rate | Discount Rate | | | |
|---|---|---|---|---|
| | **10%** | **12%** | **14%** | **16%** |
| **60%** | 1,20 | 1,15 | 1,11 | 1,07 |
| **70%** | 1,75 | 1,67 | 1,59 | 1,52 |
| **80%** | 2,67 | 2,50 | 2,35 | 2,22 |
| **90%** | 4,50 | 4,09 | 3,75 | 3,46 |

Source: Gupta and Lehmann, 2005, 26

CLTV of a segment can be easily estimated using this table. If, for example, a segment has a discount rate of 12%, retention rate of 90% and annual margin for its customer is 100 €, the lifetime value of one customer is approximately 400 € (i.e. 4,09*100 €). The table also shows the value of retention: if discount rate remains the same, increasing retention will affect the multiple significantly. For instance, if retention rate rises from 80% to 90%, while discount rate stays at 12%, CLTV increases from 250 € to 409 € (assuming 100 € annual margin). The difference indicates the maximum amount of money that should be used for retention activities. In addition, this indicates that to establish financial value, marketing actions to increase retention have more impact than financial engineering regarding the discount rate. (Gupta and Lehmann 2005, 25-27)

The strengths of this model are: (a) it does not require large amounts of data, (b) it is designed to be clear to both executives and investors of a company, (c) it is simple to use and understand, and (d) it provides a good approximation of CLTV. (Gupta and Lehmann 2005, 24) However, if this model is too simplistic for certain business areas, more sophisticated methods can be used.

According to Hogan *et al.* (2002) basic CLTV models have many deficiencies. Adjusting for the differential risk of various customers is one of them. The first problem is that the same discount rate is used for every customer. This leads to undervaluing longtime customers and overvaluing prospects. This problem is already resolved in the model presented here, since different discount rates are used for different segments. The other problem Hogan *et al.* (2002) mention is double calculation of risk. Firms are usually mostly considered about the risk of defection, which is therefore explicitly included in many models. Hence, defection risk is already included in the calculation when cash flows are discounted. The discount rate should be lower for models where defection risk is already included in order to avoid double calculation of risk.

Hogan *et al.* (2002) are also concerned about capturing social effect in CLTV models. A customer's contribution to firm's profitability is increased when positive word-of-mouth (WOM) is taken into account. The amount of new customers acquired with the help of WOM can be significant. This is especially true in some industries (e.g. services, such as hair salon), where the risk of the purchase is high and the availability of proper information is low. They also note that product lifecycle and external forces, such as competition and economic situation, are not usually taken into account. However, in order to keep the model simple, these factors are not included in the model presented here.

A CLTV calculation (i.e. customer base analysis) is the first step in managing profitable customer retention. After this, target segments and appropriate marketing actions can be selected. Also these phases exploit CLTV. Finally, after the implementation of retention strategies, results can be observed. Again, CLTV is used as a tool of analysis. Next, this process is discussed in detail.

## 3.3 The Process of Managing Profitable Customer Retention

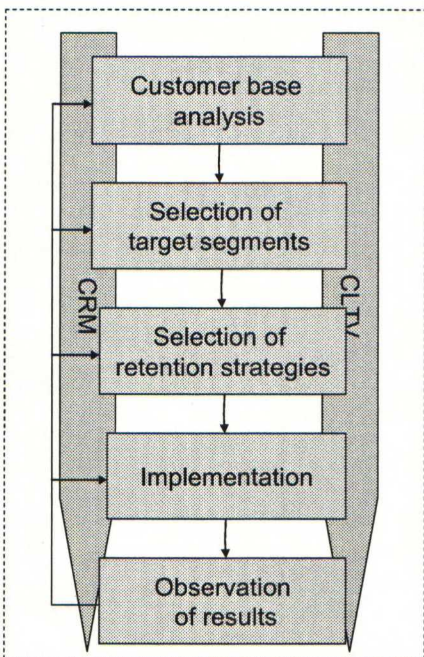
Changing retention rates in not free. Increasing retention is difficult and requires lot of resources, but when it is done well, the effects on profitability are remarkable. Increasing retention rates requires changes in the whole firm: systems, processes and even culture must be rebuilt to support retention. Retention rates can be increased by spending more on retention programs or improving the effectiveness of existing programs. The latter is usually preferred, but unfortunately it is often not a feasible strategy. (Blattberg *et al.* 2001; 68, 80)

According to Ahmad and Buttle (2002) the theory of customer retention can help managers to plan, implement and measure retention strategies. However, as noted by Kumar and Petersen (2005), appropriate strategies vary across industries and even across firms in the same industry. Thus, firms must consider practical implementation issues such as the objectives if the owners, nature of product / service and the type of customer. The created strategy should specially mach to available information and business needs.

Xevelonakis (2005) proposes a framework for building effective customer strategies based on customer behavior, customer profitability and customer risk. Customers should be segmented and a firm should develop criteria for selecting the most appropriate ways to enhance retention in that segment. The way to understand customer behavior is to use customer data. Customer risk can be managed by analyzing customer base in order to find potential defectors and then implementing suitable retention strategies. A firm should only invest in profitable customers. As noted by Bell *et al.* (2002), the challenge is to maximize, not only measure, CLTV. Next, the model of managing profitable customer retention is introduced. This model helps to find the optimal retention strategy for each segment.

There are five steps in the process (see Figure 3.2). The first concentrates on evaluating the customer base. After that target segments are selected based on the profitability and riskiness of the segments. Then, appropriate retention strategies are selected and implemented. Results are observed during the last stage. CLTV is actively used in every phase to ensure that only profitable actions are taken. CRM is the enabling factor in the process. In the end, profitable customer retention is achieved.

**Figure 3.2: The process of managing profitable customer retention**




The structure of the rest of this Chapter will follow the presented framework. Evaluating customer base and selecting target segments are covered in Chapter 3.3.1, and selecting retention strategies in Chapter 3.3.2. Finally, implementation and observation of results will be discussed in Chapter 3.3.4.

### 3.3.1 Customer Base Analysis and Selection of Target Segments

***Customer base analysis***

The process starts with customer base analysis. CLTV, which was introduced in the previous Chapter, is the basis for the analysis. First, CLTV for each segment is calculated. This provides information about the customer portfolio on an aggregate level. For example, the following questions can be answered:

- How many of the customers are profitable and how many are not?
- Is there enough profitable segments?
- What kind of customers are missing from the portfolio?
- Which segments could become more profitable?
- Which segments are in risk of defecting?

CLTV analysis can help to choose what kind of customers should be added or decreased from the customer portfolio. Some customer types might be under-represented and some over-represented; some kind of customers lack from the portfolio and some shouldn't be there at all. This kind of data can be analyzed and actions to retain or acquire customers can be taken. Sometimes it might even we wise to "fire" some customers. (Ryals 2003a) This does not mean denying business from any customer, but not giving any incentives to the wrong customers (Kumar and Petersen 2005). The CLTV evaluations made in this phase serve as basis for actions taken later.

***Selection of target segments***

When offering incentives and rewards to the customers, it is very important to realize that spending resources to wrong customers is waste of time and money. Customer retention is sometimes created at a price that exceeds the value of the customers. Hence, customers benefit from the firm and reduce its profits. Thus, allocating marketing resources to customers should always be tied to optimal financial outcomes. (Kumar and Petersen 2005)

Segments to be targeted are selected based on their lifetime value. This enables the firm to allocate its marketing budged to relevant segments and thus, increase the profitability of the customer base. Two kinds of customers are targeted: those with high or medium margin and low risk and those with high margin and high risk. These target groups are discussed next.

*Profitable customers with high CLTV*

According to Xevelonakis (2005), high value customers who are about to defect are the main target for retention campaigns. However, this is not the only target group for retention strategies. It is better to proactively reward the best customers, since it might be too late to act after they are already considering defecting. Hence, customers with high CLTV are considered the main target group here.

As discussed before, not every customer is worth of acquiring or retaining. Some customers do not contribute significant value to the firm; some might even cost to be retained. (Kumar and Petersen 2005) Some customers bring low revenues, but high costs. Clearly, these customers are not profitable and should be get rid of, if the future cash flows do not justify keeping them. Hence, profitable segments must be identified.

Only the customers whose future contribution to firms' profitability looks promising should be targeted in retention strategies. The length of customer relationship influences profitability (Buckinx and Van den Poel 2005) either positively or negatively. The longer a good customer stays the more profits it contributes. However, the longer a bad customer stays the more it can destroy shareholder value by for instance requiring constant service.

As discussed in earlier Chapters, a loyal customer might not a profitable one. Thus, retention and profitability must be managed at the same time. As noted by Kumar and Petersen (2005) it is as important to be selective within a loyalty program, or any other retention strategy, as it is within the whole customer base. Marketing spending should be allocated only to those customers who create value to the firm. Any resources invested in retention without considering profitability may lead to failure (Kumar and Shah 2004). If unprofitable customers are treated with rewards, the costs of the program will soon outweigh revenues.

Buckinx and Van den Poel give an example of unprofitable customer retention strategy. A company wants to increase retention rate and hence, they analyze the determinants of defection. This analysis is done for the whole customer base and the result is that possible defectors leave because of the absence of fast checkouts (i.e. cash registers which are only available to customers with limited amount of purchases). As a result, the company invests in fast checkouts. Some of the customers are now more satisfied and willing to stay as a customer. However, it is the unprofitable customers (i.e. those who buy only a couple of products at a time) who benefit from this change; the profitable customers who buy large amounts are not affected. Hence, defection is decreased, but profits are probably not increasing.

*Profitable customers at risk*

Some of the risky customer may be worth of keeping because of the high margin they create. However, these customers should not be kept at any cost, but the possibility and costs of changing their defection behavior must be analyzed and decision about the retention spending must be made based on that information.

CLTV can help finding the customers who are in risk to churn. These segments can be selected as target for retention campaigns. Data about customers who have defected can be compared with a control group of retained customers in order to identify what kind characteristics or behaviors predict defection. (Ryals 2003b)

As discussed earlier, total defection is not the main concern of grocery retailers. It is more important to find those customers, who might defect partially. Buckinx and Van den Poel (2005) note that partial defection can lead to total defection, and thus, it is essential to be able to recognize possible partial defectors early, when retention strategies can still be used. Partial defection can lead to significant losses, since the defectors analyzed here are the profitable ones. In order to affect the profitability of the whole customer base, it is essential to keep the best customers.

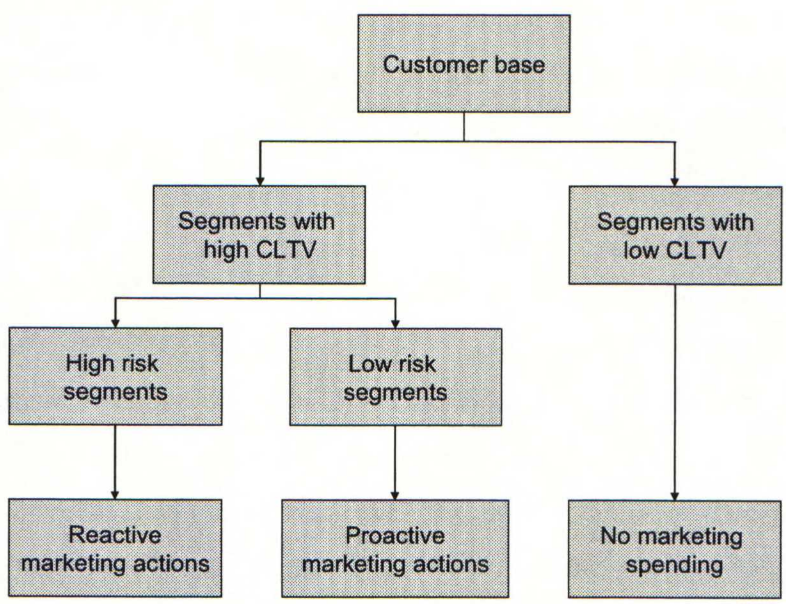
Additional research of the reasons to defect is needed before defining the content of retention strategy. Identifying possible defectors is only a starting point in the process of managing customer retention. Alternative tactics should be tested to find out where the marketing resources are best spent. Focus groups or one-to-one interviews with possible future defectors can be used to determine the reasons of defections. (Buckinx and Van den Poel 2005)

After profitable customers are identified, other information must be added. Data mining tools enable firms to add geographical and demographical information to the CLTV analysis (Ryals 2002). Purchase history is also important background information about the customers. When the characteristics of the target segments are identified, relevant marketing actions can be planned.

Figure 3.3 summarizes the selection of target segments. First, the customer base is divided to segments with high and low CLTV. No marketing investments are made in segments with low CLTV. However, if the decision maker feels that these segments can be made profitable, actions can be taken. But generally, resources shouldn't be wasted on these segments.

A segment can have high (or medium) CLTV if it is profitable and low risk or if it is profitable and high risk. High margin and low risk segments are the best customers. Retention spending on these is proactive: they are rewarded to keep the risk of defecting low and to encourage cross- and up-selling. Segments with high margin and high risk need reactive actions. When these partially defecting segments are identified, retention strategies must be used to keep them.

**Figure 3.3: Target segment selection based on CLTV**



### 3.3.2 Selection of Retention Strategies

Selecting marketing actions based on CLTV has traditionally been popular in firms that practice direct marketing. Bell *et al.* (2002) suggest that CLTV based resource allocation can be applied in other product categories, too. However, this might be challenging. It might be difficult to manage customers based on their value and at the same time treat everyone fairly or at least make them feel like they are treated fairly. For example price discrimination has not been successful. Other problem is that it is still difficult to make resource allocation decisions that are future orientated. Finally, it might be very challenging to find a way to maximize the value creation for both customers and the firm.

Choosing the right retention strategy includes two decisions. First, the target segment and its characteristics must be analyzed to decide the nature of the action. For example, if the target segment consists of mothers of young children, baby club can be introduced. The risk of the customer must also be recognized i.e. is the customer possibly defecting or not. This information helps to decide the right method and the right timing of the action. Second, the decision about the amount of money invested in marketing action must be made. This can be done by analyzing changes in CLTV.

In order to plan retention strategies, more information than profitability and defection possibility of a customer is needed. Reinartz and Kumar (2000) used discriminant analysis in their research to predict demographic characteristics of the customers in a certain segment. Data mining can be used to predict the most relevant reward for a certain customer or segment (Kumar and Shah 2004).

Firms must be careful with add-on selling. It must be carefully thought who will be the target group and which products will be sold (Blattberg *et al.* 2001, 123) since customers can be irritated by unwanted add-on selling attempts. Ryals (2003b) recommends cross-buying analysis for identifying which products or services are usually bought together. This can be used in developing promotions: cross tabs can suggest which offers are most likely to succeed in certain segment. Cross-buying analysis can also prevent companies from dropping products with low sales that are an important part of purchasing mix from the customer's point of view. This information can be linked with customer lifetime value analysis, which might reveal low sale products that are important for highly profitable customers. This might be important information for manufacturer when it is offering low sale products for retailers. The existence of these products can be justified with the fact that dropping them will jeopardize the entire relationship with highly profitable customers.

Another analysis method introduced by Ryals (2003b) is collaborative filtering. It assumes that customers with similar purchasing patterns have similar taste. Hence, if one customer from a certain segment starts buying a new product, the other customers are likely to also be attracted to the new product. This information can be used for personalized offerings. This can be done in collaboration with retailers and manufacturers: retailer shares the information about possible buyers and both parties participate in planning the promotion.

Once the right customers are identified, the optimal contact method and frequency must be determined. This will allow the firm to optimize its returns from each marketing communication (Kumar and Petersen 2005), since the frequency and methods of contacts will reflect on the purchasing behaviors of that customer and thus, help to maximize CLTV (Rust *et al.* 2000). There must be different contacting frequencies and methods to low- and high-value customers. Contacting the right customers using the right amount of resources will increase profitability and the financial performance of the firm. (Kumar and Petersen 2005)

According to Kumar and Petersen (2005) it is not enough to contact the right customers; the message must be right and it must be send at the right time. Hence, the firm must be able to predict the next possible product that the customer might want. Sending right messages at the right time will increase the response rates and hence improve the financial performance of the firm.

Loyalty programs and retention campaigns are often based on behavioral loyalty. They reward customers based on the amount of purchases (monetary amount or times visited). As noted by Kumar and Shah (2004), profitability of the customers is not taken into account if frequency or monetary amount is the basis for rewards. These do not tell anything about the margins of the products bough. Thus, customer buying high- or low margin products or services receive the same benefits. It is clear that this not lead to optimal, profitable customer retention.

Retention strategies to be implemented can be planned with the help of CLTV. The effect of different actions can be modeled and the most desirable action can be chosen. Each action has a different cost, different acceptance rate by the customers and different effect on revenues. With this information, a new CLTV, which estimates the effect of the action, can be calculated. This is then compared to the current CLTV and the CLTV of the other actions. The action with highest CLTV is then chosen assuming that it has higher CLTV than the current situation. (Rosset *et al.* 2003) Every marketing action should justify a positive return on investment for every customer (Kumar and Shah 2004). Recent research by Lewis (2004) shows that simulation studies can be conducted to investigate the relative power of different marketing actions. By adding appropriate cost information, the profitability of given actions can be analyzed, and hence, the optimal action can be chosen.

The following information is needed for predicting CLTV
(Rosset *et al.* 2003):

- The cost of the campaign; including the cost of communication and the cost incurred if the customer accepts the incentive (e.g. the cost of selling two at the price of one),
- The probability that a customer who is approached will accept the incentive,
- The effect on retention rate, and
- The change in the margin, if the incentive is accepted.

This information can be used for selecting marketing tactics and later for observing results.

**Figure 3.4: Retention Strategy Selection Based on CLTV**

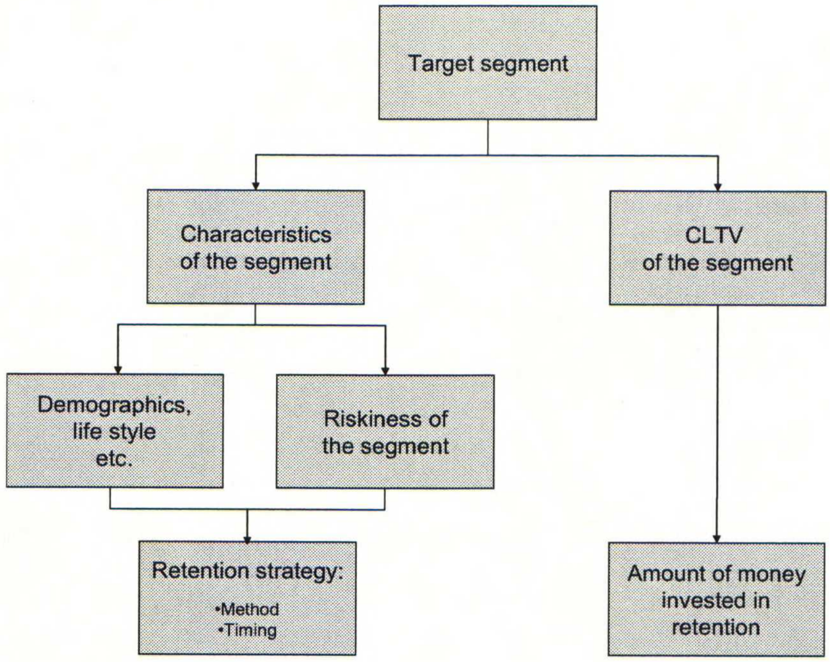



Figure 3.4 summarizes the selection of marketing actions. When target segment is selected, its characteristics and CLTV are analyzed. Retention strategy (method, timing etc.) is planned based on the demographics, lifestyle and other characteristics. The riskiness of the segment influences especially the timing of the marketing action.

Analyzing the CLTV and possible changes in it helps to decide how much money is invested in retention of the segment. The predicted return on investment (ROI) should always be positive.

Even if decisions are made on segment level, customer level strategies can be used. For example, if customer belongs to high profitability and high risk segment, special offers can be made to him. The value of these offers depend the CLTV of the customer, which is same to every customer. However, the exact content of the promotion can be defined at customer level. Hence, the campaigns can be targeted to whole segments or to individual customers. As the data bases and tools develop, most of the offerings can be made at customer level.

### 3.3.3 Implementation and Observation of Results

***Implementation***

After segments to be targeted are selected and the plan about retention strategies is done, the chosen retention strategy can be implemented. The information captured from previous phases, such as demographics of the segment, will help in implementation. This is the phase where actual action takes place: promotions are run, loyalty programs are introduced or changed etc. The details of this phase are not captured here. After marketing actions are implemented, results can be observed by recalculating the CLTV.

***Observation of results***

CLTV can be used for observing the results of retention strategies. After implementing a certain actions, changes in CLTV can be analyzed. Observing results is an important phase in the process. Leanings from the previous actions can be used to improve future operations. Unfortunately, this is the phase that is most often skipped.

As discussed in previous Chapter the following information is needed for calculating the new CLTV (Rosset *et al.* 2003):

- The cost of the campaign; including the cost of communication and the cost incurred if the customer accepted the incentive (e.g. the cost of selling two at the price of one),
- The amount of customers who were approached that also accepted the incentive,
- The effect on retention rate, and
- The change in the margin, if the incentive was accepted.

The information is the same than in the simulation phase but now all the Figures are known based on the actual actions and their effects.

Observation should be a continuous process. A firm makes ongoing investments in retention depending on customer information. By observing the results of retention strategies continuously, companies can learn about the effects of their marketing actions and adjust their strategies accordingly. (Hogan *et al.* 2002)

# 4 COLLABORATION AND PARTNERSHIPS BETWEEN RETAILERS AND SUPPLIERS

As noted in the beginning of this study, relationship marketing is replacing traditional transactional marketing. This is especially true in business-to-business markets. Collaborative relationships are based on the assumption that collaboration creates synergy i.e. both parties are getting more than they would get alone. The competition is not between individual firms; it is the value-chains that are competing.

Mohr and Spekman (1994) define partnerships as follows:

> *Partnerships are ... purposive strategic relationships between independent firms who share compatible goals, strive for mutual benefit, and acknowledge a high level of mutual interdependence.*

Ploetner and Ehret (2005) add to this by stating that vertical partnerships are a specific type of relationships which are based on mutual dependency and trust and where both supplier and its customer are committed to collaboration beyond buyer-seller transactions. The coordinated effort of supplier and distributor is focused on jointly satisfying the needs of the end customers (Anderson and Narus 1990).

Partnerships are usually formed to gain competitive advantage. Great benefits, such as:

- Access to new technologies and markets,
- The ability to provide wider range of products and / or services,
- Economies of scale in production, marketing and research and development,
- Access to knowledge and complementary skills,
- Sharing the risk of doing business, and
- Improvement of performance indicators, such as sales, market share and profitability

can be gained from partnerships. (Mohr and Spekman 1994; Tuten and Urban 2001; Ploetner and Ehret 2005) The common vision of future benefits drives the partnership (Ploetner and Ehret 2005).

However, as noted by Mohr and Spekman (1994), partnerships can also be risky. For instance, increasing complexity, loss of autonomy and information asymmetry may be results of partnerships. To avoid these risks, partnerships must be carefully managed. The success factors that lead to flourishing partnerships are discussed in Chapter 4.2. These factors can be used in selecting partners, as well as in managing the relationship in the long run.

Working with a partner is not necessarily easy. Firms must move towards processes and behavior that support close working relationships. Only this way the benefits of the partnerships can be achieved and the risks can be avoided. This Chapter concentrates on partnerships. General characteristics and success factors are discussed first. After that, retailing specified partnerships are covered by discussing ECR. Finally, examples of possible ways of collaborative customer retention strategies are given.

## 4.1 Characteristics of Partnerships

The differences between transaction based relationships and partnerships are shown in Table 4.1 (based on Dwyer *et al.* 1987; Buono 1997; Tuten and Urban 2001; Ploetner and Ehret 2005). Partnerships grow slowly, but they also last longer than transactional relationships. The exchange between partners is an ongoing process rather than just separate transactions. The relationship is based on trust and desire to develop future business with the other party. Transactional relationships are based on contracts, since the parties do not know each other well. Partnerships, on the contrary, can be formal or informal (Tuten and Urban 2001). Some partnerships are based on formal contracts, but some rely solely on shared norms (Ploetner and Ehret 2005) and the word of the other party.

**Table 4.1: Traditional Transaction Based Relationships versus Partnerships**

| *Dimension* | *Transaction Based Relationship* | *Partnership* |
|---|---|---|
| **Time Frame** | Short-Term | Long-Term |
| **Development of Relationship** | Quickly | Slowly |
| **Information Flow** | One way | Two way, interactive |
| **Control** | Traditional hierarchy | Multidisciplinary, teamwork |
| **Profit Orientation** | Buyer controlled | Mutually controlled |
| **Commitment** | Based on clear, defined series of transactions | Based on trust and development of of future business opportunities |
| **Exhange** | Transactional | Ongoing process |
| **Oblications** | Based on contract | Based on shared norms |
| **Personal Relationships** | Not important, ritual-like communication predominate | Important, both formal and informal communication is used |
| **Parties Involved** | Few executives, sales and purchasing | Cross-organizational and cross-functional teams |
| **Transferability** | Complete transferability; it does not matter who fulfills contractual oblications | Limited transferability; exhange is heavily dependent on the identity of the parties |
| **Co-operation** | No joint efforts | Joint efforts related to both planning and implementation |
| **Measurement and Observation** | Little attention to measurement and observation; performance is obvious | Significant attention to measuring and observing results |
| **Power** | Impact only the contract negotiations | Impact th whole relationship because of interdependence of the parties |

Partnerships are based on cooperation in planning and implementation. Measurement of results is also important (Dwyer *et al.* 1987), because it enables both parties to evaluate the relationship and improve it further. Profit is the concern of both sides (Buono 1997), since the objective is to grow the "pie" for both.

Personal relationships become more important in partnerships because of the length and deepness of the relationships. Hence, the transferability becomes limited in partnerships i.e. partners cannot be changed easily (Dwyer *et al.* 1987).

Partnerships do not work only on executive level (Buono 1997). Many parties from different levels of organization are involved in cross-functional and –organizational teams. Hence, control is not based on traditional hierarchy, but on teamwork and shared control.

Good relationships are said to be based on equal balance of power (Tuten and Urban 2001). However, there is a debate about the distribution of power in the retail sectors. It has been said that the power has shifted to the retailer's side. Nevertheless, no matter which party has more power, the other party must be treaded as though both parties had equal power. By showing power, mistrust is created and the partnership won't succeed (Tuten and Urban 2001).

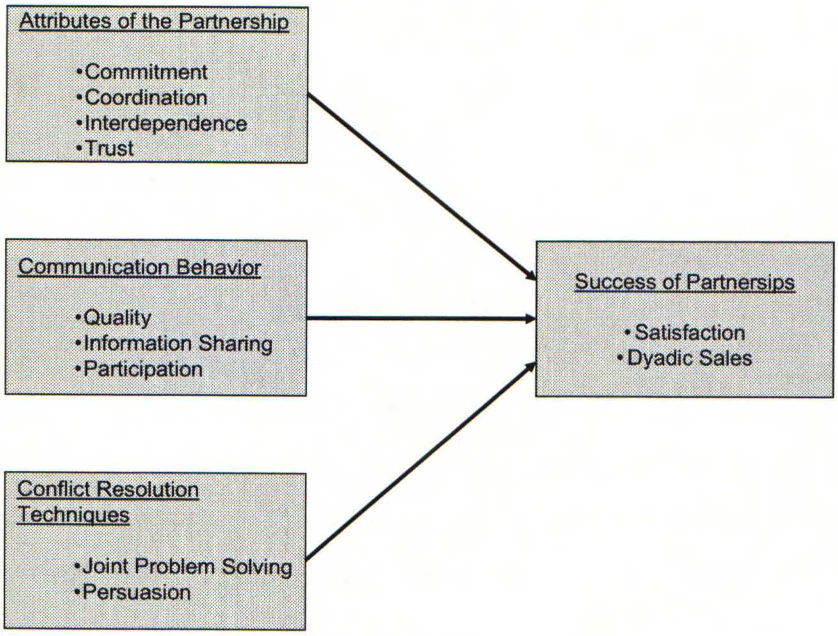
Power in the marketing context is more and more based on information. Retailers are gaining a role as channel leaders because they have the access to loyalty card data. Even if information brings power, that power is not diminished when it is shared. Conversely, by managing information well, the retailer can reinforce its role in the distribution channel. (Ziliani and Bellini 2004)

## 4.2 Success Factors of Partnerships

According to Mohr and Spekman (1994) strategic partnerships are formed to achieve certain goals (e.g. increased profitability, better service to end customers etc.). Hence, the attainment of such goals indicates relationship success. For example, if the goal of the partnership of a retailer and a supplier is increasing customer retention, the success can be measured by observing retention rates.

Figure 4.1 illustrates the model constructed by Mohr and Spekman (1994), in which they propose that partnership success is predicted by relationship attributes, communication, and conflict resolution techniques.

**Figure 4.1: Factors Associated with Partnership Success**




Source: Modified from Mohr and Spekman, 1994

Attributes of successful partnerships are commitment, coordination, interdependence and trust. Commitment is shown by being willing to exert effort on behalf of the relationship. The boundary definition and expectations of the tasks that other party will perform are related to coordination. Coordinated and consistent actions will lead to success. Interdependence is related to the loss of autonomy and, on the other hand, to the increase of benefits due to partnership. Both parties need to recognize that partnering will provide more benefits than either party can attain separately. Trust, i.e. the belief that other party's word is reliable, is a prerequisite for successful relationship. (Mohr and Spekman 1994) According to Anderson and Narus (1990), co-operation will lead to trust, which leads to better co-operation, which generates more trust and so on. Hence, trust is an important antecedent of successful partnership.

The existence of these attributes indicates that both partners value the relationship and are ready to work for the survival of it (Mohr and Spekman 1994). Willingness to achieve win-win situation is essential because any opportunistic behavior will harm both parties (Ploetner and Ehret 2005).

Communication is critical to the success of a partnership. According to Mohr and Spekman (1994), quality of communication, information sharing and participation are important factors in relationships. The accuracy, timeliness, adequacy and credibility of information exchanged are indicators of quality. These enable the achievement of the shared goals.

Information sharing refers to the extent of critical information sharing between partners. Information sharing enables effective operations and improves satisfaction of the partners. (Mohr and Spekman 1994) Durable partnerships can only be created if both parties are willing to share information. According to Ziliani's and Bellini's (2004) survey, an ideal partner for co-operative campaigns is not necessary the market-leader, but a supplier who is willing to share information and develop win-win promotional activities.

Jointly planning and goal setting (i.e. participation) ensures mutual expectations of the outcomes of the partnership, and hence, commitment to the shared goals. Partners need to participate in specifying roles, responsibilities and expectations in order to work successfully together. (Mohr and Spekman 1994)

According to Ploetner and Ehret (2005) conflicts exist in partnerships almost inevitably. The foundation of a partnership is based on economic objectives, such as performance and profit. Consequently, partnerships are both competitive and collaborative. The partners will expand the "pie" collaboratively, but might compete on the portioning of the pie. Thus, understanding the impact of conflicts is important. The resolution of conflict can be productive or destructive. Hence, conflicts can harm or improve relationships. When partners engage joint problem solving, mutually satisfactory resolution can be reached, and hence, the partnership can be improved. (Mohr and Spekman 1994)

Conflicts can be resolved in many ways which either harm or improve partnerships. According to Mohr and Spekman (1994) successful partnerships will exhibit higher use of constructive resolution techniques, such as joint problem solving and persuasion. Less successful partnerships will probably use destructive resolution techniques, including domination and harsh words, as well as arbitration and avoiding issues.

Tuten and Urban (2001) criticize the view that conflict resolution techniques are antecedents to partnership success. They emphasize the importance of good communication as a proactive way to avoid conflicts whilst conflict resolution is seen as reactive response when problems have already emerged. However, as stated previously, conflicts are almost inevitable in every relationship. Hence, partners must be ready to solve them in a constructive way.

## 4.3 ECR –Collaboration in Grocery Retail Sector

ECR (efficient consumer response) is a strategy developed by the grocery industry in 1993. It is a result of specially-formed industry project consisting of industry trade associations and a consulting group, Kurt Salmon Associates, Inc. The objective of the project was to streamline the grocery supply chain. Given the intense competition among grocery retailers, improving customer satisfaction and reducing cost became essential for the survival of the companies. Managing inventories in the face of changing customer needs is a challenge for grocery retailers because backordering is not a viable option. Hence, the supply chain participants must work together to overcome the challenges of the industry.

ECR is defined by the Joint Industry Project for Efficient Consumer Response (1994, ref. Hoffman and Mehra 2000) as following:

> (ECR is) *a strategy in which the grocery retailer, distributor and supplier trading partners work closely together to eliminate excess costs from the grocery supply chain. The ECR strategy focuses particularly on four major opportunities to improve efficiency:*
>
> 1. *Optimizing store assortments and space allocation to increase category sales per square foot and inventory turnover.*
> 2. *Streamlining the distribution of goods from the point of manufacture to the retail self.*
> 3. *Reducing the cost of trade and consumer promotion.*
> 4. *Reducing the cost of developing and introducing new products.*

ECR is not a strictly defined doctrine, but a combination of different management methods which are then adapted to fit to retailing. Hence, ECR may be defined differently by different parties. (Finne and Kokkonen 2005, 147) For instance, QR (Quick Response) and JIT (Just in Time) have had an effect to the development of ECR.

The implementation of ECR is based on long-term partnerships among all channel members: suppliers / manufacturers, distributors, brokers and retailers (Hoffman and Mehra 2000). According to Brockman and Morgan (1999), ECR is the most advanced phase of integration where channel players are working together to identify and respond to the needs of the end customer. Even if the benefits of vertical integration were recognized in the beginning of the 20th century, channel player continued to work autonomously. Still, mistrust and competition between channel members hinders co-operation to some extent.

ECR has the same goals as partnerships in general: increasing competitive advantage through serving the end customers better and reducing costs at the same time. ECR emphasizes the importance of meeting quickly the needs of the end customer: offering more and better products on lower prices. ECR is a "win-win-win" strategy: it benefits the supplier, the retailer and the end customer (Finne and Kokkonen 2005, 146).

Successful implementation of ECR requires the existence of the success factors introduced in Chapter 4.2. Communication, co-operation and coordination among all partners must be managed well in order to succeed (Hoffman and Mehra 2000). Mutual trust must be established among all partners in the early phase to be able to share information. Information sharing is essential when implementing ECR. As noted by Hoffman and Mehra (2000), inventories are replaced by information. The efficiency and effectiveness of the supply chain depends on accurate, on-time data which is used in marketing, production and logistics decisions.

Organizational power play should be avoided at all cost when implementing ECR (Hoffman and Mehra 2000), since, as stated previously, power based on size shouldn't be used in partnerships. Power exertion can easily harm the relationships between the partners and lead to suboptimal results.

As noted before, measuring results is an important part of partnerships. This is also true in ECR operations. According to Finne and Kokkonen (2005, 148) activities and processes in the supply chain are constantly measured and the value added for the customer is analyzed. If an activity or a process does not add any value, it must be removed or improved.

ECR consists of four distinct but related tenets (see Figure 4.2). These cooperative strategies create superior value to the consumer at a lower cost.

**Figure 4.2: Four Basic ECR Strategies**

| Efficient Replenishment | Efficient Promotion | Efficient Store Assortment | Efficient Product Introduction |
|---|---|---|---|
| • **Optimising time and costs**<br>➢ Just in time logistics<br>➢ Automated ordering<br>➢ Exhange of take-off data via EDI<br>• **Increasing service to consumers** | • **"Total systen efficiency" to better plan and replenish promotions**<br>➢ Minimise handling costs (administration, storage, transport, personnel)<br>➢ Create know-how base and enable faster reaction to changing consumer demand | • **Optimising store inventories**<br>• **Optimising self space**<br>➢ Increase m^2/ft^2<br>➢ Higher stock-turns<br>➢ Placement guidance or standardisation according to local shopping bahavior | • **Optimising product development**<br>• **Controlling launch of new articles**<br>➢ Better testing possibilities<br>➢ Immediate response to consumer acceptance or rejection |

Source: ECR Europe 1997

*Efficient replenishment* links the consumer, retailer and supplier into integrated system. Information between the partners is shared quickly through EDI linkages which enables just in time logistics and automated ordering. Better collaboration between retailer and supplier enables more efficient product flow and fewer out-of-stocks for the end customer. (ECR Europe 1997)

*Efficient promotion* enables planning promotions that mach better to the demand of the consumer. It helps building the best mix of consumer-oriented promotions within categories while minimizing costs. (ECR Europe 1997)

*Efficient store assortment* provides starting point for optimum use of store and self space. This is done by offering the right assortment to the consumer and hence, enhancing business results for both retailers and suppliers. (ECR Europe 1997)

The goal of *efficient product introduction* is to develop more consumer-oriented products at lower cost. The cooperation between retailers and suppliers enables creating better products to meet unfilled or only partially fulfilled consumer needs. (ECR Europe 1997)

ECR is based on the use of point-of-sale (POS) data to update inventory and replenishment orders in real time (Hoffman and Mehra 2000). Corsten and Kumar (2005) speculate that suppliers become gradually dependent on smarter retailers. ECR is based on knowledge and data-intensive processes which make it necessary to have access to the customer databases to be successful. These databases (e.g. loyalty card data and POS-data) are usually the property of retailers. By sharing this data, the whole value chain can gain competitive advantage.

ECR has shifted the focus from supply-based approach to more market-focused management. It combines the entire marketing mix in distribution decisions. Joint decisions in price, place, product and promotion issues are made by the channel members. ECR's fourth tenet –efficient product introductions- indicates that new product development is also part of the distribution function. (Brockman and Morgan 1999)

According to the research of ECR Europe, advanced use of ECR has increased sales and profitability of suppliers. Retailers have been able to improve retention rates because customers have been more satisfied with the offering. (Finne and Kokkonen 2005, 150) Thus, collaboration can be used to enhance retention.

## 4.4 Collaboration in Managing Customer Retention

The process of managing profitable customer retention was introduced in Chapter 3. Retailer and supplier can cooperate in every step of the process. The retailer can provide information about the customer base to the suppliers. This information can be then used to plan and implement collaborative marketing actions. The retailer and the supplier can choose the target segments and retention strategies together. Collaboration in the implementation phase ensures effective and efficient operations. As noted in the previous Chapter, "total system efficiency" can be created to better plan and replenish promotions. Later, results for both parties can be analyzed and improvements can be made. This collaborative process benefits both retailers and suppliers; and finally, the end customer, who is getting better and more meaningful rewards.

This Chapter provides examples of possible co-operation in managing customer retention. Many countries are way ahead of Finland in taking advantage of POS-data and customer information from loyalty programs. One of the reasons why Finland has not been able to benefit from all the promotional possibilities is that the law hinders many of the activities. Some of the collaborative retention campaigns implemented abroad would not be possible in Finland at the moment, but the situation might change in the future. Hence, not all the examples here are relevant to Finnish retailers and suppliers at the moment, but they might provide interesting insight of the future.

Managing customer retention together requires openness and willingness to share information on both sides (Ziliani and Bellini 2004). This is a risk, but also an opportunity for both sides. Traditionally, retailers have been secretive about their data, which has given them more power in the negotiations. However, such secrecy may hinder co-operation and result in worse outcome for both parties. Suppliers can use the customer data to learn more about their customers and to refine their targeting. In order to use customer information based marketing tactics, suppliers need to gain access to the databases of retailers.

Ludgi and Ziliani (ref. Ziliani and Bellini 2004) have investigated possible co-operation areas among Italian suppliers and retailers. They found out that suppliers were mostly interested in stock-out and brand share data whereas retailers were mostly willing to share loyalty card data. From 1999 to 2002 the amount of information shared has risen. In 2001 82% of respondents exchanged POS-scanner data, 63% shared loyalty card data and 55% shared a mix of POS and loyalty card data. Interestingly, the number of retailers expecting monetary compensation from sharing the information has decreased (from 88% in 1999 to 65% in 2002). This is because more and more retailers believe that sharing information creates value to both parties.

Retailers can sell or share both raw data and readily analyzed data. For example, Tesco provides finished research to its suppliers through its controlled research firm DunnHumby. The data is analyzed and reported as the supplier wants. (Ziliani and Bellini 2004) This system benefits both parties: Tesco gets better prices for the data and the supplier pays only for relevant information that is ready for using.

As mentioned in Chapter 3, loyalty programs in the future will rely on partners more than today. Wider range of rewards is offered to customers, which cannot be done without the help of partners. A good example of this is Nectar, a UK based loyalty program. Customers can earn points from different companies (e.g. Sainsbury's, Debenhams, Ford, Herz and bp). Rewards vary from small gifts, such as wine and CD's to bigger rewards, such as holidays and helicopter lessons. Every customer can find something to fit their needs and wants. It is also easier to collect points for bigger gifts since they can be earned from many sources.

Another example of collaborative retention strategy is an Italian retailer Nordiconad and two of its suppliers (Pampers and Plada). They created the "special baby card", which provides benefits, information and discounts to mothers who buy Pampers or Plada products. This promotional activity benefits both the retailer and the supplier because it helps to build brand and store loyalty at the same time. (Ziliani and Bellini 2004)

Another Italian retailer, Interdis, joined forces with Kraft to promote Kraft's Milka and Interdis' own label juice. Coupons offering free juice for purchase of three Milka chocolate bars were mailed to customers who had bought chocolate products during the last six months. Only the customers, who had bought several different chocolate brands, were targeted, since it is easier and less aggressive to target customers, who are not totally loyal to competing brands. (Ziliani and Bellini 2004)

Using very precise targeting based on purchase history can be extremely aggressive strategy. For instance, Italian retailer Nordiconad and Procter and Gamble wanted to increase the market share of Swiffer (Procter's brand). Coupons were mailed to loyal customers of Pronto, a rival brand of floor cleaners. The campaign was a success; Swiffer became the leading brand in the category. However, this is a very aggressive and possibly even illegal tactic since other suppliers are discriminated against. The aggressiveness of tactics can be reduced by concentrating on retention campaigns rather than trying to acquire competitors' customers i.e. targeting only those customers who already buy your own brand. Hence, goodwill between the retailer and the other suppliers can be maintained. Targeting the own, profitable customers have also other benefits: the cost of marketing actions stays low and customers are more likely react to the campaigns. (Ziliani and Bellini 2004)

The collaboration between retailer and supplier can affect both vertical and horizontal relationships. It opens different kinds of vertical partnership opportunities; their nature and duration varies depending on the objectives. Vertical partnering can be very durable, but usually it is better to change partners every now and then in order to avoid becoming too dependent on one supplier. For the same reason, retailers are not usually eager to promote the leading brand, but help the followers to gain market share. (Ziliani and Bellini 2004)

If a retailer partners with competitive supplier, as happened with Procter and Gamble and Pronto, the other supplier might partner with rival retailer. Consequently, the horizontal competition increases between the suppliers and also the value chains. However, not many retailers are willing to encage such a risky strategy even if suppliers might be eager to target competitors' customers. (Ziliani and Bellini 2004) It can be a good strategy in the short run, but will probably harm both parties in the long run.

# 5 THEORETICAL SUMMARY AND THE FRAMEWORK

In this chapter, the theoretical part of this study is summarized and the framework of reference is introduced. The purpose of the theoretical part of this study is to find an answer to the research question: How can profitable customer retention be managed collaboratively by retailer and supplier?

The theoretical part started with the introduction of relationship marketing and CRM as basis for the discussion. Then, customer retention was examined. First, retention was defined: *The customer continues to purchase the product or service over a specified time period.* Then, customer equity theory and the role of customer retention in it were presented. Retention equity, alongside value and brand equity, is one of the drivers of customer equity. The role of retention in customer portfolio theory was covered and the conclusion was made that retention is linked to acquisition and defection. The determinants of customer retention were introduced and the special characteristics of customer retention in retail sector were discussed. Especially, partial defection was discussed.

The third Chapter concentrated on managing profitable customer retention. First, retention strategies were introduced and customer lifetime value as basis for management of profitable customer retention was discussed. Finally, the process was introduced.

Partnerships and collaboration between retailers and suppliers were covered in the last Chapter. The characteristics and success factors of partnerships were introduced first. Then, ECR as grocery retailing specific partnership was discussed. Finally, examples of collaboration in profitable customer retention management were given.

The framework, illustrated in Figure 5.1, is based on the discussed theories. CLTV is the basis for profitable retention. It shows what the current customers are worth to the firm now, based on the predicted future profits. In this context, CLTV is estimated to every segment, not for every individual customer. Decisions about resource allocation are made based on CLTV: retention strategies and target segments are selected based on it.

Loyalty programs, retention campaigns and other strategies can be used for enhancing customer retention. Other strategies, such as improving service and introducing better products, are necessary antecedent of customer retention; loyalty programs and campaigns only work if the company can create value to the customer and deliver the expected quality. All of these strategies are meant to influence the determinants of retention. By increasing the effect of the determinants, retention is enhanced.

The seven determinants of retention are loyalty mechanisms, value, customer expectations vs. delivered quality, product uniqueness and suitability, switching barriers, customer service and ease of purchase. In general, customer expectations versus delivered quality and switching barriers affect retention. By meeting or exceeding customer expectations in the rest of the determinants, retention can be enhanced.

Retention can be enhanced by creating superior value to the customers. Value can be determined as price-quality ratio or perceived benefits versus perceived sacrifices. The latter is more appropriate since the monetary price is not the only cost for the customer and other benefits than quality can be important. Other determinant, ease of purchase, can affect the perceived value. Proximity, speed of shopping, traffic in the area, parking facilities and opening hours are important to the customer.

Products and services are important determinant of customer retention. The quality, uniqueness and suitability of the product affect retention. In grocery retailing, other important aspects of the product are the freshness and range of the products. Also the physical store has an effect on retention. The atmosphere and personnel of the store are part of service. Loyalty mechanisms, such as loyalty programs, link usage and rewards and hence, generate retention. Loyalty mechanisms can also serve as switching costs.

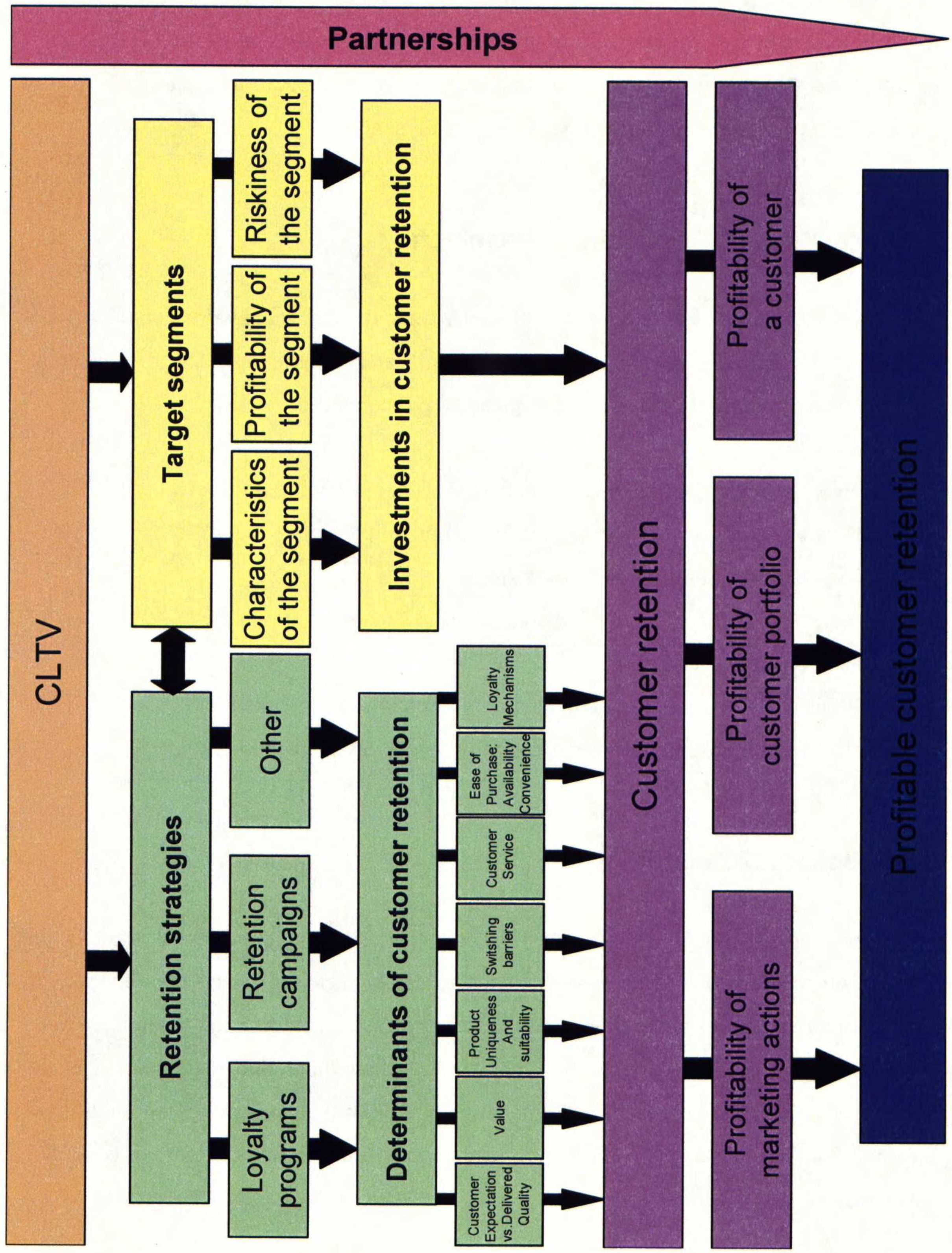
The characteristics, profitability and riskiness of a target segment are taken into account in retention strategies. Target segments characteristics (e.g. demographics and life style) affect the selection of retention strategies. The profitability and riskiness of the segment influence the amount of money allocated to each segment and each retention strategy. Every marketing action should have positive ROI.

Profitable customer retention is influenced by selecting right segments and right strategies. The profitability of customer retention comes from three sources: 1) profitability of a single customer is improved, 2) the profitability of the customer portfolio is improved, and 3) the profitability of marketing actions (retention strategies) is improved.

The profitability of some customers can be increased by lowering costs and increasing revenue. For example, customers can be directed to lower cost channels, such as Internet. Cross- and up-selling can be used to sell more and more profitable products. When decisions about marketing spending are made based on CLTV, the profitability of the retention strategies is enhanced. This also increases the profitability of a customer, since marketing costs are allocated to customers. By increasing the amount of profitable customers (and decreasing the amount of unprofitable customers) in the customer portfolio, the profitability of the whole company can be improved. In the end, profitable customer retention i.e. increased CLTV, is achieved.

Partnerships are related to the whole framework. Both retailers and suppliers can benefit from the collaboration in managing customer retention. By sharing information, planning and implementing retention strategies together, better results can be reached. However, this is only possible if partnership is successful. The success of partnership is predicted by relationship attributes, such as commitment, coordination, interdependence and trust; communication, and conflict resolution techniques.

**Figure 5.1: The Theoretical Framework**



# 6 METHODOLOGY

The empirical study is based on the interviews of four representatives of grocery retailers, five suppliers and two experts. The empirical study concentrates on profitable customer retention in grocery retailing and the management of it. In addition, partnerships are covered as they relate to customer retention management.

## 6.1 Objectives of the Empirical Research

The empirical study concentrates on the elements of the framework: value of the customer, customer retention, target segment and marketing action selection, determinants of retention, retention strategies and partnerships.

The objective of the empirical research is to answer the following questions:

1. How customer retention is seen in case companies?
2. How the profitability / value of customer is measured?
3. How profitability / value of customers is used in decision making?
4. How customer retention is managed?
5. What is the role of partners in customer retention management?
6. How customer retention management will develop in the future?

## 6.2 Research Methodology

This study is qualitative in nature. The case research method was chosen as an appropriate method to find an answer to the research question. Data was obtained by semi-structured, face-to-face interviews. Both Finnish retailers and suppliers were interviewed: representatives from two major retail chains and five major suppliers. In addition, two experts on grocery retailing were interviewed in order to gather additional information. Due to the scope and nature of the study, sample size of approximately ten was considered appropriate.

The sampling methods used in this study are judgmental sampling and snowball sampling. The interviewees were chosen based on the judgment and expertise of the researcher. In addition, experts were used to select the most appropriate interviewees. The interviewees were chosen on the basis of their presumed expertise of the subject.

The themes of the interview are based on the theoretical framework. The form used in the interviews is enclosed as appendix. The sequence of topics and questions was set up in a logical order, but the interview was allowed to proceed in the interviewees' own sequence. However, care was taken that all the topics were discussed.

Respondents were first contacted by telephone. The interviews took place in February and March 2006 in the respondents' premises. The list of questions was sent to interviewees beforehand. The themes were discussed freely as the interviewees' answers guided the discussion. All of the interviewees gave a considerable amount of information and explained the themes from their points of view. Each interview took approximately one hour (ranging from 40 to 80 minutes).

In order to secure reliability, interviews were tape-recorded and later transcribed. The analysis of the results was then made based on the written notes. Pattern- matching (Yin 1989, 125) is the method used in the analysis. Both of the cases (retailer and supplier) are compared to the theoretical framework and to each other.

## 6.3 Reliability and Validity

The evaluation of the accuracy and applicability of the data involves an assessment of reliability and validity. These terms are mostly used when quantitative research methods are used, but similar requirements can be applied also to qualitative research.

*Reliability* refers to the extent to which consistent results are produced if repeated measurements are made i.e. it refers to the lack of random error (Malhotra and Birks 2006, 313). The reliability of this study is good. All the interviews were recorded and carefully transcribed later. Most of the interviewees checked the parts of the written text that was based on their interview to control that the researcher had understood the interviewee right. The analysis is based on these checked, written documents. Therefore, the risk of human mistake is low and thus, the probability random error is minimized.

*Validity* indicates the degree to which an instrument measures what it is supposed to measure (Malhotra and Birks 2006, 314). There are three types of validity measures: internal validity, external validity and construct validity (Yin 2003, 34-37). Internal validity is only used in causal or experimental studies (Yin 2003, 37). Hence, it is not relevant in this study.

External validity is used to test whether the findings of the study can be generalized. Case studies cannot be statistically generalized as quantitative studies, but analytical generalization can be used. The theory used in the study can be used for identifying other cases to which the results are generalizable. (Yin 2003, 37) Consequently, this study is not statistically generalizable, but it can be analytically generalized to other studies about profitable customer retention management.

Construct validity addresses the question of what construct or characteristics the scale is measuring (Malhotra and Birks 2006, 315). Construct validity in this study was enhanced by ensuring that relevant items were investigated. The questions and themes of the interviews were well prepared. The themes were drawn from the theoretical framework. The researcher was also well prepared for the interviews and familiar with industry and the terms used in the field. In addition, the interviewees as experts of the subject presented the best information available about the topic thus enhancing the validity of the research.

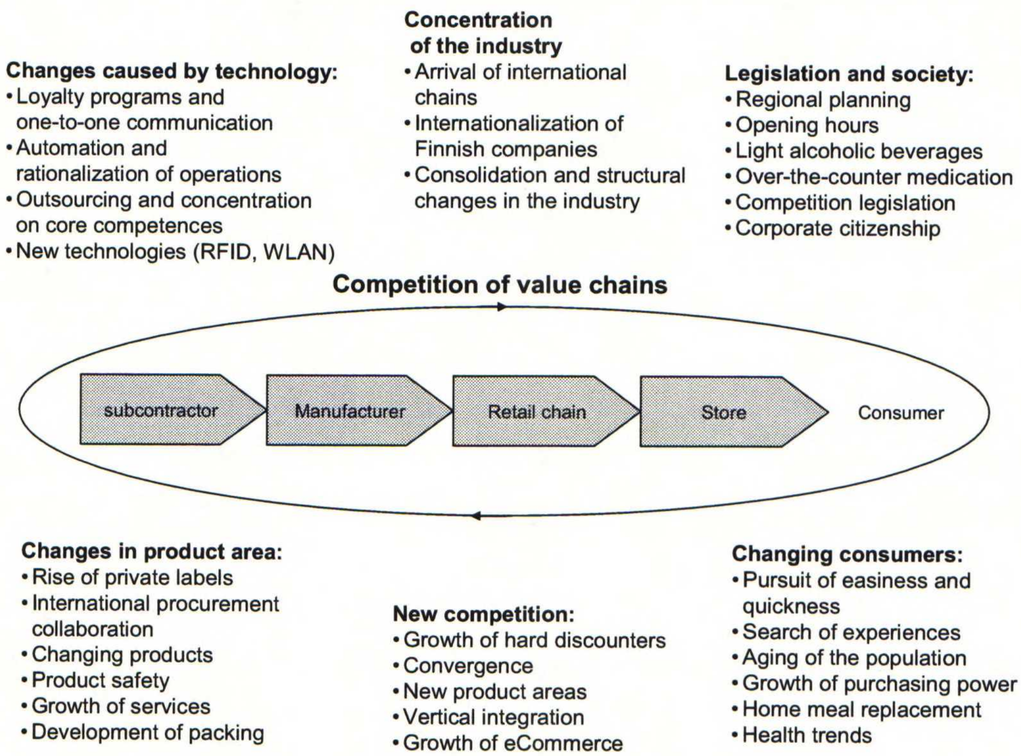
# 7 EMPIRICAL FINDINGS

This Chapter concentrates on the empirical findings of this study. First, Finnish grocery retail industry is introduced briefly. Then, findings from the interviews are presented. Both retailers' and suppliers' views are summarized. In order to secure anonymity, no names of the interviewees are mentioned in the text. Finally, empirical findings are compared to the framework presented earlier.

## 7.1 Key Characteristics and Future Trends in the Finnish Grocery Retail Industry

This study concentrates on Finnish grocery retail industry. It has many special characteristics that affect the way of doing business. These characteristics and the future challenges in the industry are introduced in this Chapter. Figure 7.1 summarizes the main characteristics and change forces in the industry. Next, each of these forces is discussed briefly.

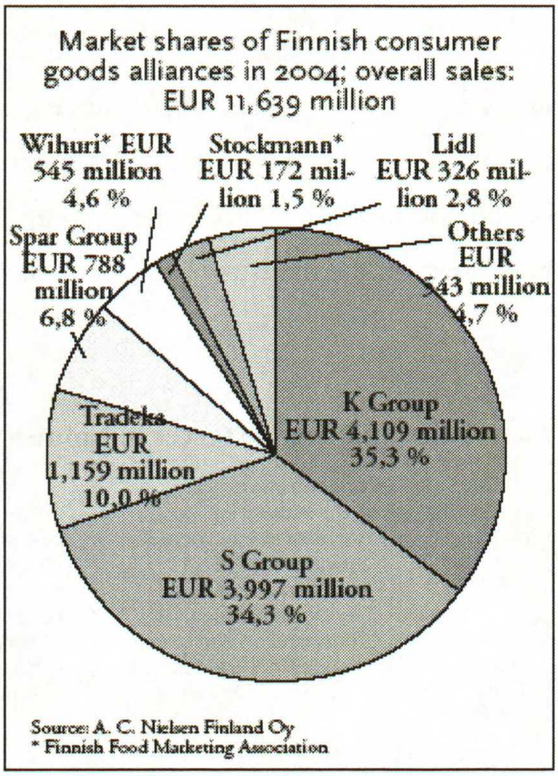
**Figure 7.1: Main characteristics and change forces in Finnish grocery retailing**




Source: Finne and Kokkonen (2005, 22)

*Concentration of the industry.* The overall sales of Finnish grocery retailing industry were about 11,6 million Euros in 2004. Grocery retailing is highly concentrated in Finland. Chain stores accounted for 92,5% of the overall trade in 2004. As illustrated in Figure 7.2, the three largest alliances K Group, S Group and Tradeka had 79,6% of the market share. The high level of concentration is common to all Nordic countries. Large volumes are essential to achieve sufficiently efficient operations in vast and sparsely populated countries.

**Figure 7.2: Market shares of Finnish consumer goods alliances in 2004**




Grocery retailing is also concentrated in terms of sales per store. The number of market-type shops has decreased from over 9000 in 1978 to 3500 in 2004. The importance of large shops increased: 10% of the shops account for 51% of total sales of fast moving consumer goods. (Päivittäistavarakauppa 2005)

There have been many mergers and acquisitions recently. Elanto stopped collaborating with Tradeka and merged with HOK (Helsingin Osuuskauppa) in 2004. Next year, Tradeka and Wihuri joined together. At the same, the ownership of procurement and wholesale companies started to change. S-Group and Tradeka owned Inex Partners together, but on 31 of January 2006 they announced that SOK will acquire all shares in

Inex Partners and Inex will become a wholly-owned subsidiary of SOK. The latest acquisition in the industry took place in the beginning of 2006, when S-Group bought Suomen Spar.

Concentration is also a trend on the supplier side. Many international and global companies have acquired Finnish suppliers: Nestle bough Valio's ice cream business, Felix Abba acquired Panda, Scottish & Newcastle bought Hartwall and Carlsberg bought Sinebrychoff.

Internationalization is closely related to concentration of the industry. As mentioned, many international firms have acquired Finnish suppliers. Grocery retailing is usually very local. However, some chains are starting to expand their operations abroad. So far, Lidl is the only international chain in Finland. Finnish retailers have been more active in foreign operations. The most important areas of expansion are Sweden and the Baltic States. (Finne and Kokkonen 2005, 30-34)

*New competition.* Hard discounters change the competition in the industry. Price has become the most important factor in competition. The rise of eCommerce has not affected grocery retailing yet. Vertical integration towards the end of the value chain has enabled chains to become closer to the customer. Unnecessary middlemen are removed from the value chain. Hard discounters control their value chain very strictly to be able to keep costs down.

The industry is also affected by convergency and structural changes. The roles of different player are changing and the offerings are becoming more versatile. For instance, grocery retailers begin to offer products that are traditionally sold in specialty stores. (Finne and Kokkonen 2005,41)

*Changes in product area.* Internationalization and product development have increased the range of products in Finnish groceries. Global brands are part of every store's category. On the other hand, the popularity of private labels is growing. Hence, retailers are taking part in product development and using their knowledge about end customers. Other trends in the product area are safety and healthiness. Recent epidemics have made customers aware of possible dangers of food. As noted by one of interviewees, healthy food is no longer valuable per se. The trend has developed and taste has become more important. The healthiness of a product is taken for granted; taste is the differentiating factor. Packages of the products are developing since consumers are more concerned about the ingredients of products.

*Changes caused by technology*. Loyalty programs are very common in Finland. These were discussed in earlier chapters. Loyalty programs enable the increase in one-to-one communication. Campaigns can be targeted to small segments or even individuals. However, many of the interviewees noted that too detailed plans do not work, since the business is based on volumes.

The purpose of ECR is to make the value chain more efficient. This is done by automating many activities. New technologies (e.g. RFID) enable better and more efficient operations. Outsourcing and concentration on core competences are also affected by technology.

*Changing consumers*. Customers do not belong to single category anymore. As noted by one of interviewees, a consumer can buy microwave meals during the week, but purchase high quality raw materials for home made meals in the weekends. Easiness and speed are valued by the customers, but on the other hand, taste has become very important. Aging of the population and the increasing amount of people living alone has affected the offerings of grocery stores. Healthiness and safety are important, as noted before.

*Legislation and society*. Grocery retailing in Finland is more regulated than in most of the other European countries. Shops are not allowed to keep their doors open as they will. For example, opening hours on Sundays are very limited. Over-the-counter medication and wine cannot be sold in grocery stores. The Finnish VAT on food is one of the highest in EU: the average is 5% in EU is 5% whilst the Finnish VAT is 17%. According to Osmo Laine (Päivittäistavarakauppa 2005), the Finnish regulation should be changed quickly to mach the current situation in the market.

All of these trends affect the whole value chain. In the competition of value chains, the one who responds best to these change forces will gain competitive advantage. As noted by Kautto (2006), the new competitive advantage comes from ability to quickly adjust to the changes in the industry. Price competition is the most important trend at the moment, but it will be interesting to see how the market evolves. Will the Finnish grocery retailing industry continue to emphasize low prices as in Germany or will something else become important to customers?

## 7.2 Retailers' Point of View

Representatives from two major retailers in Finland were interviewed for this study. This chapter summarizes the main findings from these interviews.

### 7.2.1 Customer Retention

Customer retention is defined as repeat buying by the retailers. Customer relationship is born when the customer gets a loyalty card and ended when a certain time has gone by without any use of the card. As noted by the interviewees, monitoring up- and downward migration is more important than following retention rates. This is because customers usually defect only partially rather than totally. Hence, partially defecting (passive) customers are identified and actions are taken to keep them. The frequencies and monetary values of purchases are monitored to predict partial defection.

Customer retention is very important to retailers, since it is the way to make money. However, not all the customers are worth of retaining. The retention of the best customers has a significantly bigger effect on profitability than the retention of average customers. Some of the customers might even be unprofitable. The retention of these customers can harm the profitability of the company.

Retailers are more concerned about the retention rate in certain segments than in the whole customer base. These value based segments are defined by using RFM (recency, frequency, monetary value). Customer retention is followed by analyzing the changes in the amount of customers in each segment and the amount of money they are using. The development of sales (€) and the number of customers in each segment is monitored mainly on monthly and annual basis. However, retailers are also interested in the retention of the whole customer base, since sufficient volumes must be reached to cover fixed costs.

*Determinants of customer retention*

The interviewees mentioned the following determinants of retention: location (proximity), a habit of going in a certain store due to the location of the store, easiness and speed of shopping, meeting the expectations of the customers, the physical appearance of the store, product range (local assortments), emotional bonds, the personnel of the store, price, quality, service, marketing actions and loyalty programs.

Location is seen as the most important factor affecting customer retention. As noted before, customers are not willing to travel long distances to get to grocery store. Hence, if a certain store is not located near to the customer, it is unlikely that he will stay as a customer. However, the right location is not necessary the nearest location. Easiness and speed of shopping are more important. For example, parking facilities, traffic and opening hours influence the choice of primary shopping place. The proximity and assortment of the store affect customer retention most. Customers might be willing to patronize a store that is not the nearest one, if the assortment meets their needs better than elsewhere.

About 15% of people move during one year; this affects customer retention. It is not applicable to try to keep the customers if they move to a place where the competitor's store is much closer. Sometimes customer retention is affected purely by location. If customers do not have alternative service providers nearby, they are forced to stay with the current one.

Customer retention can be increased by meeting or exceeding the expectations of the customers. Product range, service and price level are important to customers. Hence, by improving these factors, customer retention can be increased. Marketing actions, such as advertising and campaigns, can be used to increase retention. All of these actions are planned to serve the customers that the retailer wants to target.

Price seems to be very important to customers nowadays. However, quality and service appeal to certain segments. These customers might be more profitable and easier to retain than the ones who are only interested in price. In following the differentiation strategy, the uniqueness of quality and service are ways differentiate one's offering and avoid pure price competition.

The personal relationships with store personnel can be a strong bond between customer and the store. Emotional bonds due to relationships or other factors tie some customers to a store or the whole chain. These factors create more constant competitive advantage than price alone.

*Retention strategies*

All kinds of retention strategies are used to keep the customers. Loyalty programs and retention campaigns are used to increase retention. Both monetary and non-monetary rewards are used. Non-monetary rewards have become more important, since monetary rewards do not offer sustainable competitive advantage. Especially the best customers are treated, for example, with the variety of events.

However, the interviewees agree that loyalty program alone does not improve customer retention. Customers are more willing to change loyalty cards than stores, if they are happy with the store they patronize at the moment. Customers are mainly loyal to the store, not to certain chain. As noted before, customer's expectations must be met to improve retention. Customer retention is not possible, if the basics do not work: the location must be right, right products must be available and the price level must be low enough. As noted by Kautto (2006), loyalty programs and campaigns only work if the customer is satisfied with the offering and service level of the store.

### 7.2.2 Customer Profitability and CLTV

Measuring customer profitability (or customer lifetime value) is not as sophisticated in grocery retail industry as it is in for example banking. According to the interviewees, it is more important to be familiar with the customer's lifestyle and behavior. More important metrics than profitability or lifetime value are for example share of wallet and the attitudes of customers.

Customers are segmented based on profitability (A, B, C and D customers). However, this is done based on RFM, not on CLTV. RFM model is also used for profitability calculation. Customer profitability is followed on segment level since it is not appropriate to analyze the profitability of a single customer. Because of the importance of volumes, customers should be observed and decisions should be made on adequately high level.

Detailed calculations about customer profitability are not made even if data is already available. This is because the information cannot be used, since the processes are not developed enough. Hence, the processes must be improved to be able to take advantage of the existing data.

As noted before, the customer profitability calculations are still work in progress. At the moment, only gross margins on sales are actively followed explaining most of the costs that can be allocated to a specific customer. In considering profitability, the effect of marketing costs that can be allocated to a customer, should be taken into account in the customer specific calculation models of profitability.

The interviewees think that it is complicated and difficult to decide which costs should be included in the customer profitability calculations. Only variable costs are included at the moment, the role of fixed costs is not decided yet. In addition, the allocation of marketing costs is not always straight forward especially in the case of TV and print advertising costs.

The profitability of a customer differs considerably during the different phases of life. For example, parents with small children have significantly better profitability than aging customers living alone. Hence, it is important to recognize the current phase of life and estimate possible changes in it. This affects especially customer lifetime value calculations, since change in phase of life influences the profitability of the following years. According to the interviewees, the more loyal and committed the customer is, the more profitable he probably is.

Customer profitability is also followed with the help of GIS (geographic information system). Customer profitability is linked to the postal codes or addresses of the customers. This information is used in marketing decisions, such as the use of media or direct marketing. Profitability calculations are also linked to POS data to analyze the profitability of single shopping basket.

Customer lifetime value is also calculated annually, but it is not used as much as monthly customer profitability analysis. The behavior of customers is predicted for the next couple of years and the lifetime value is estimated based on these predictions.Even if customer lifetime value is not actively used, there is a need to identify customers who will be profitable in the long run.

Customer data is stored from the couple of previous years. It would be too expensive to keep all the data in the data warehouse for decades. Thus, information from the whole customer lifetime is not available and, obviously, the rest should be made with forecasts in estimating forthcoming years.

### 7.2.3 Managing Profitable Customer Retention

Decisions about marketing are already made based on expected profitability. Decisions based on the customer lifetime value are also made to some extent, but it is not fully utilized yet. New technologies enable producing better knowledge about customers. However, the usage of the information is still developing and not all of the possible data is utilized. The use of the data will probably develop significantly in the near future.

Customer information is used for two purposes: 1) improving the assortments in the stores, and 2) improving the effectiveness of marketing. Assortments in stores are very similar at the moment due to strong control in the chains. However, customer information can be used for finding better assortments that fit to the needs of the local customers. Sending the right message to the right customer at right time will result in better effectiveness and hence, profitability of campaigns.

*Selecting target segments*

Decisions about resource allocation are not made purely based on customer profitability or lifetime value. The main problem is the size of the segments; if only the best customers are targeted, volumes are not big enough and the effect of the campaign to overall profitability is minimal.

However, the rewards of loyalty programs are based on purchasing volumes and hence, in most cases, also profitability. Thus, the best customers are rewarded. Some of the interviewees mentioned that it might be wise to use other criteria than purchasing volumes, too. Nevertheless, rewards based on customer profitability or lifetime value are probably too difficult to implement and communicate to customers.

Different amount of marketing resources are allocated to customers. Some of the campaigns are already made only for the best customers. Cross and up-selling is also planned based on customer information. It is essential to keep the most valuable customers. Obviously, the effect of losing a best customer is significantly bigger than losing an average or bad customer. However, customer profitability or CLTV is not widely used as basis in resource allocation decisions. Instead, other segmentation criteria (e.g. demographics) are used.

The target segments of retention / cross- and up-selling campaigns are sometimes selected based on the RFM model (i.e. the amount of purchases). However, the changes in profitability of the customers are analyzed after the campaign. In addition, the ROI of each campaign is monitored.

Even if CLTV is not used in decision making, some resource allocation decisions are made based on the belief that the targeted customers will be profitable in the future. Thus, the basic idea of CLTV is used, but without any exact calculations.

As the interviewees noted, it is important to control who will stay as a customer. Customer retention can be unprofitable even if almost all of the customers of grocery retailers are profitable. Retailers are willing to let go the "wrong" or "bad" customers. However, they are not actively fired, but the amount of resources allocated to them is decreased. If marketing resources are used to increase the amount of unprofitable customers (e.g. those who buy only products on sale), the profitability of the whole customer base is reduced. Hence, marketing actions that increase retention of wrong customers should be eliminated. This is not yet done, but data and tools are available.

On the other hand, volumes are essential to grocery retailing since the fixed costs are high. Thus, the amount of customers becomes more important than customer profitability. Sometimes it is even crucial to acquire unprofitable customers to reach sufficient volumes.

*Selecting marketing actions*

Customer retention is increased by both proactive and reactive marketing actions. The best customers are rewarded to keep them from defecting. Defection is reduced by monitoring partial defection. Reactive marketing actions are taken to keep the customers who are already starting to defect. It is important react as soon as possible, since it is more expensive to try to get the customers back if they have already switched their primary shop.

The aim of the marketing actions is to increase the amount of purchases by encouraging cross- and up-selling. Hence, the profitability of a single customer is enhanced. Customer profitability can be enhanced by developing the customer relationship. By cross- and up-selling, the value of average purchase can be increased and hence, the profitability of the customer can be enhanced.

Mass marketing is not an effective way to increase the customer retention. Instead, customized campaigns are effectively used to influence the target segments including the best customers as well as the customers who have lately decreased their purchases significantly. However, complicated campaigns will not succeed in grocery retailing. It is easy to plan a good campaign, but it is not easy to make it work in the field. Enough products must be available in the stores and the personnel must be aware of the campaign and its rules to succeed.

The profitability of marketing actions is analyzed and decisions are made based on it. Both short term and long term profits are estimated before the action based on historical data. The ROI of marketing actions has become very important. Results are observed after actions are taken. Sometimes results are observed for a long time after the action has been taken in order to monitor the long term effects. Results from the previous marketing actions are used to improve the effectiveness of the future actions.

### 7.2.4 Partnerships

Partnership is a strategic choice for a retailer. Close relationships with partners are sought. However, not all of the suppliers are seen as potential partners. Thus, closer relationships are formed only with selected suppliers. These partners should be able to help the retailer to gain competitive advantage. According to the retailers, it is essential that the supplier understands the needs of the end customer. Partners must find ways to meet the needs of the customers collaboratively. Joint planning helps to cut costs in the supply chain and, hence, the profitability of both parties is enhanced.

Partnerships are developing all the time as both parties learn how to benefit from collaboration. Better information sharing has led to increased cooperation. Retailers are willing to share information to achieve mutual benefits. By linking retailers and suppliers customer data, better understanding of the end customer can be achieved and hence, the competitiveness of the whole value chain is increased. For instance, suppliers and retailers are developing products together based on customer information. However, there are some legislation restricts regarding the information sharing between partners set by authorities. Customer information is partly confidential and the usage is limited.

There is no deep collaboration in planning marketing actions at the moment. For example, campaigns are not planned collaboratively from the beginning. In addition, partnerships have not brought any added value to customer retention management yet.

Retailers do not want to influence the product choices of the customers in the store. It would not be fair to other suppliers to promote only one brand. In addition, if all the products in the category have the same profitability (from the retail point of view), it does not matter which of them is bought. Hence, long term campaigns that favor only one supplier are not appropriate. However, short term campaigns are used to improve the retention rates of both parties' customers.

### 7.2.5 Future Business Models

The Finnish grocery retailing industry is changing fast at the moment. All the available information can be used more effectively in the near future since the processes will develop and enable fact based management. Customer data will be analyzed more and decisions will be based on it. The development of the customer relationship will be analyzed more carefully: up- and downward migration is followed, the effect of marketing actions is measured and the influence of price can be analyzed more precisely.

The most important segments must be analyzed carefully based on customer information. Campaigns can be planned more specifically, but one-to-one marketing will probably never succeed in Finnish grocery retailing. Instead, customization can be used to better target the offerings. Affinity groups and customer community programs are a growing trend in grocery retailing. Clubs for customers with varying interests (hobbies, life style etc.) will probably be more common in the future.

Proactive marketing actions will be more important in the future. The needs of the customers can be predicted, for example based on life cycle, and proactive actions can be taken. Better use of information will improve the effectiveness of marketing actions. By connecting customer data to profit and loss statement, analysis about the drivers of customer profitability can be made. Customer profitability will receive more attention not only among the marketing managers but also at the higher levels of organization. Hence, appropriate measures must be developed to provide information about the customer base.

The importance of partners will increase in the future, since companies will concentrate more on core competences. Partners are used to widen loyalty programs and to provide better value to the customers. The collaboration between retailers and suppliers will become deeper: more information is shared and marketing actions are planned together.

## 7.3 Suppliers' Point of View

Five major Finnish suppliers were interviewed for this study. This chapter summarizes the main points from the interviews.

There were some problems defining who the customers are. For a supplier, the retail chain is the primary customers and the consumers are the end customers. Suppliers feel that they do not have direct customer contact to the consumers. Hence, there was more concentration on supplier-retailer relationship than on end customers. In addition, some of the suppliers concentrated more on products than on customers; especially in profitability issues.

### 7.3.1 Customer Retention

Suppliers define customer retention as repeat buying. Repeat buying is essential; especially in the case of new products. Some of the interviewees also mentioned that customer retention to them means the same than customer loyalty. Customer retention as a word was not easy to understand according to some interviewees, since it is not used in their organizations.

Retention is followed by analyzing the amount of repeat purchases for each product. Customer information is connected to this data in order to recognize what kind of customers remain. This analysis is quite easy nowadays, since detailed information is available. However, some of the suppliers observe only repeat purchases per product; repeat purchases of a single customer are not monitored.

Customer retention is also tracked by monitoring market shares, sales and brand related metrics (e.g. attitudes towards the brand and awareness). The buying preferences and attitudes are followed to predict the future success of a brand or product. Thus, loyalty or intention to buy is also an important metric alongside actual purchases.

Partial defection is more meaningful than total defection. Customers migrate up and down rather than totally stop buying a certain brand. According to some of the interviewees, changes in customer retention are quite small because of large product portfolios. If customers decrease the buying of some products, the effect on total sales is usually quite small.

Customer retention is essential for the survival of the company. The retention of end customers affects the retention of retail customers. Suppliers feel that they should get closer to the end customer. Some of the suppliers have tried to increase the direct connection to end customers. This enables them to get their own customer register which makes it easier to monitor customer retention.

*Determinants of retention*

The following determinant of retention were mentioned in the interviews: meeting or exceeding the expectations of the customers, the products, brand, familiarity of the brand / product, price, switching barriers, quality, price-quality ratio, a habit of buying a certain product, availability of the products and easiness of finding the product in the store.

Customer retention can be increased by taking the customer into account from the beginning. Product development should be driven by customer needs. The main reason why customers stay is that their expectations are met of exceeded. Brand is also important factor, even if most of the fast moving consumer goods are low involvement products. Consumers are willing to buy products they already know. Hence, the familiarity of the brand is important. Some customers have a habit of always buying a certain product. These customers can be easily retained, since they are not willing to try new brands. However, these customers can also be lost, if the product is eliminated from the assortment.

New products are important to segments which look for change. These customers cannot be retained, if new products are not launched every now and then. In addition, wide product range is needed to keep the variety seeking customers.

Price is an important determinant of customer retention for some products and some segments; especially if the product has a lot of substitutes i.e. the switching barrier is low. However, competing purely based on price will not create sustainable competitive advantage. Suppliers see a need for quality and differentiating based competition. Hence, price-quality ration also affects retention. By offering the best value to the customers, retention can be achieved. Value can also consist of abstract benefits, such as status or sense of belonging.

Availability of the products is essential. Customers can only be retained if products are easily available in the stores. In addition, products should be available in every possible place where customers might want to buy them. Layout and the place in the self affect customer retention. If a certain product is not available or easily found, customers will probably try competitor's products. This will influence the retention rates of the supplier. In addition, lacking products can also affect customer retention from retailer's point of view; customers will choose another store if they do not find the products they are looking for. Thus, it is in both parties best interest to ensure product availability.

*Retention strategies*

The interviewees mentioned the following ways to increase customer retention: campaigns, communication and brand building. New products are advertised heavily in order to encourage repeat buying. However, no marketing action can save a product if it does not meet the expectations of the customers. There is no use keeping the products which are not valued by the customer in the assortment, since it harms both the retailer and the supplier.

### 7.3.2 Customer profitability and CLTV

As mentioned before, the primary customer for a supplier is the retail chain. The profitability of retail chains as customer can be easily analyzed. The analysis of the value of a chain is based on current profitability, predicted future profitability and partnership potential. The profitability of retailer customers is monitored carefully. Decisions about resource allocation are based on value based segmentation. Decisions about campaigns are usually made based on retailer profitability, not end customer profitability.

Customer lifetime value of retailers is not directly estimated. However, some of the suppliers take future profits into account when segmenting retail customers. Some others recognize the need for using CLTV, but do not use it.

Suppliers do not have enough data for segmenting end customers based on profitability. Instead, segments are formed based on demographics and attitude. This information comes from own customer research and external research (e.g. A.C. Nielsen). However, profitability of these segments can be analyzed with the help of customer data from retailers. More detailed calculations than currently could be done, but it is not always appropriate. Detailed calculations require resources and do not always bring any extra benefits.

Profitability or CLTV of end customers would be beneficial to suppliers if this information was available. For example, targeted campaigns to most profitable customers could be used. Profitability information could also change the assumptions that suppliers have about the end customers and thus, enable improved operations. The data should be on segment level to enable easy analysis. Suppliers are also interested the profitability of customers to the retailer. If a supplier can show that its products attract profitable customers, the product will get more room in the store.

Some of the interviewees noted that CLTV would be better metric than profitability when analyzing the end customers. Plans are made taking the future into account and proactive marketing is used. Hence, it is natural to use future orientated metrics. The interviewees noted that the winner in the market will be the supplier who can manage the predictions and proactive actions best.

The data from retailers is not enough when analyzing profitability or lifetime value of customers from the supplier's point of view since not all the costs of supplier, such as brand advertising and logistics, are included in this data. Hence, it is necessary to link the data from retailer and supplier. This makes the calculation complicated.

The biggest problem with profitability calculations is that the cost of producing a product depends on volumes. If the sales of one product changes, the volume of production will change and the costs will be affected. Hence, the profitability of all customers buying that product is changed. In addition, other products produced in the same line are affected, which makes it extremely difficult to estimate the effect to the profitability of the customers.

### 7.3.3 Managing Profitable Customer Retention

Decisions about resource allocation are not yet made based on customer profitability or customer lifetime value. Results are mostly measured by analyzing sales and turnover effects. However, the interviewees pointed out that profitability analysis should be developed and used more in decision making since customer retention and profitability are related to each other. At the moment, resource allocation decisions are made based on the profitability of a product, not a customer.

*Selecting target segments*

Resources are allocated differently to different segments. However, the retention of whole customer base must still be considered since Finland is a small country and volumes are only reached by targeting all customers. However, the amount of resources allocated to each segment varies. Best segments are identified and most of the resources are allocated to them.

Committed customers are profitable. This is because of the higher expected cash flows in the future due to lower defection rate. In addition, marketing actions are more profitable if customers are already committed and have positive attitude towards the brand.

Campaigns targeted to certain segments are used sometimes, but the allocation decisions are based on demographic or lifestyle based segmentation. The problem with these campaigns is that the target segments tend to be too small. Hence, the campaign does not have any significant effect on total sales.

Measuring marketing actions' ROI is important but challenging task. Marketing actions are seen as investments which are supposed to create profits in the long run. Hence, CLTV is the right measure when allocating resources to segments. However, it is not yet used.

*Selecting marketing actions*

Marketing actions are selected based on the goal of the action and the expected ROI. However, profitability analysis is not used as much as it should. According to the interviewees, results of campaigns should be observed more carefully and planning should be more systematic. Also the effect of changes in offered product range to profitability should be analyzed. Nevertheless, some of the decisions are still made based on experience and feeling.

Marketing actions should be profitable for the retailer also. It is not enough that suppliers benefit from the campaigns. The problem is that campaigns often only shift the sales from one product to another. Thus, the retailer does not get any additional sales from the campaign. If the supplier can show that its campaigns create added value to the retailer for example by showing that more profitable customers are interested in the campaign, the supplier will be in better position when planning cooperative actions.

Some of the decisions about marketing actions are made based on the margin of a product. The problem is that all actions (e.g. changes in price, decisions about production) affect each other. Thus, the effect of one decision cannot be tracked easily.

Some of the products are unprofitable to the supplier. However, the profitability of the retailers buying this product is positive. Hence, these products can be seen as investments in customer relationships. If a product is unprofitable for the retailer, actions must be taken. In some cases, the product will be eliminated from the stores. However, if the supplier can prove that the product increases customer lifetime value for the retailer, the product can deserve to stay in the assortment. This might be the case with some special products, which are not bought often, but which are related to highly profitable product portfolios and thus to highly valuable customers in the long run.

Usage of customer information is not perfect yet. The interviews mentioned many problems with the current systems. For instance, the amount and complexity of information makes the analysis difficult and time consuming. However, competitive advantage can be achieved if the supplier is able to examine the data better than its competitors and offer intuitive proposals to retailers.

### 7.3.4 Partnerships

Suppliers emphasize the willingness to be the best partner in the industry. The purpose of the partnership is to manage to whole value chain together in order to create value to the end customer. By creating value to customer, value is also created to both retailer and supplier.

Some of the interviewees were concerned about forgetting the end customer. Both retailers and suppliers have been concentrating on supply chain management and thus, the relationship between retailer and supplier. However, according to the interviewees, every one should have their focus on the end customer. Hence, demand management should be emphasized more.

Partnerships have to offer more than traditional buyer-seller relationships. Suppliers expect information and knowledge sharing, collaborative learning and cooperative planning. Partners should challenge each other to become even better.

Customer retention is managed in collaboration to some extent. For example, cooperation in planning and implementing loyalty campaigns is already done. Certain segments are targeted to enhance the customer retention of both suppliers and retailers. Suppliers are interested in collaborative efforts in loyalty program management.

Customer retention is also increased by offering suitable assortments. Retailers and suppliers design the assortments together according to shared customer and market information. This ensures competitive and differentiated offerings that bring competitive advantage to both parties.

Learning from the partners was emphasized by many of the interviewees. Joint education should be used more to share knowledge. The interviewees emphasized also the importance of information sharing. Information sharing and collaborative planning lead to better marketing actions. However, truly collaborative planning is not used at the moment. For example, campaigns are not planned together from the beginning. The supplier side would be interested in deepening the relationship and thus, improving the results of marketing actions. The information and tools are ready for improving customer retention of both parties, but these are not used.

Information is already shared to some extent. Not all the relationships are considered as partnerships and hence, information is not shared actively with every retailer. Suppliers are willing to share information and knowledge to improve the results for both parties.

It is important to understand the end customer to be able to offer information to the partners. Both retailers and suppliers collect and analyse data about customers. This information should be connected in order to get a better picture about the customer. Both can learn from each other since they see the customer from a different point of view. Suppliers feel that they have lot to offer to retailers: predicting customer preferences etc., but retailers are not always willing to use this information. Suppliers would like to help retailers to differentiate their offering.

The retailer side is increasing its power, which can make it difficult to develop win-win partnerships. This harms the relationships between retailers and suppliers. Price has become more important factor in negotiations. This affects the partnerships, since trustful relationships are not easily maintained when price is the main factor affecting sales. Some of the suppliers see that the end customer would be willing to pay higher prices, but the retailers want to keep the prices down. If the supplier could show that demand wouldn't be affected by price increase, the price of some products could be raised and the margins would be improved.

### 7.3.5 Future Business Models

ECR has affected the way of making business. However, the emphasis has been mostly on supply chain management: logistics and cost reduction. In the future, the focus will hopefully shift to demand management: optimizing assortments, promotions and new product introductions.

Customer information will be used more extensively in the future. Customers expect that the information they provide to retailers will lead to better service (better assortments). Assortments will be more localized to better meet the needs of the customers. Both retailers and suppliers need to work to differentiate their offerings. Information about the profitability and customer base of a single store helps suppliers to design their offering better. Hence, they can help retailers to find the optimal range of products to each store.

Retailers and suppliers should work together to increase customer retention. There is enough data, but it s not used well enough. Concrete actions based on customer data are not taken. The amount of information used in decision making will explode. Hence, some kind of automation must be used to effectively take advantage of the vast amount of information. This will also challenge information sharing. Especially, the store level should be informed about the decided actions and reasons that led to them in order to ensure commitment in implementation. This will be essential to the success of marketing actions.

## 7.4 Comparison of the Framework and the Empirical Findings

In this Chapter, the retailers' and suppliers' points of views are compared. In addition, the results of the interviews are compared to the theoretical framework. Table 7.1 reviews the components of the framework presented earlier. Results from the interviews that are related to the framework are summarized in the same table.

**Table 7.1: Comparison of the Framework and the Empirical Findings**

| | *Retailers* | *Suppliers* | *Framework* |
|---|---|---|---|
| **Definition of customer retention** | Repeat buying or loyalty | Repeat buying or loyalty; unfamiliar word for some of the companies | Repeat buying |
| **The importance of customer retention** | Essential | Essential; especially in the case of new products | Essential |
| **Determinants of customer retention** | Location (proximity), a habit of going in a certain store, meeting or exceeding the expectations of the customers, the physical appearance of the store, product range (local assortments), emotional bonds, the personnel of the store, price, quality, service, marketing actions and loyalty programs | Meeting or exceeding the expectations of the customers, the products, brand, familiarity of the brand / product, price, switching barriers, quality, price-quality ratio, value, a habit of buying a certain product, availability of the products and easiness of finding the product in the store. | Loyalty mechanisms, value, customer expectations vs. delivered quality, product uniqueness and suitability, switching barriers, customer service and ease of purchase |
| **Methods used in esimating the value of customers** | RFM, share of wallet | The profitability of products is calculated; very limited use of customer profitability analysis | CLTV |
| **The level of analysing customer value** | Segment level | Segment level | Segment level |
| **Retention strategies** | Loyalty programs, campaigns and other strategies* | Campaigns, communication, brand building and other strategies*. | Loyalty programs, retention campaigns and other strategies* |
| **Target segment selection** | Based on demographics or other segmentation criteria; customer profitability is used to some extend, the use of CLTV is nonexistent or limited | Based on demographics of lifestyle segmentation; decisions made based on the profitability of the product | Based on CLTV |
| **Targeted segments** | Different amount of resources to different segments, but whole customer base must be targeted | Different amount of resources to different segments, but whole customer base must be targeted | Only segments with high CLTV |
| **Retention strategy selection** | Based on ROI of the action | Based on ROI of the action | Based on estimated CLTV |
| **Link between customer retention and profitability** | Profitability of a single customer is improved, the profitability of the customer portfolio is improved, and / or the profitability of marketing actions (retention strategies) is improved. | Profitability of a single customer is improved, the profitability of the customer portfolio is improved, and / or the profitability of marketing actions (retention strategies) is improved. | Profitability of a single customer is improved, the profitability of the customer portfolio is improved, and / or the profitability of marketing actions (retention strategies) is improved. |
| **Partnerships** | Partnerships have not brought any added value to customer retention management yet. | Not enough concentration on the end customer. More collaboration is needed to increse customer retention of both parties. | Collaborative effort between retailers and suppliers leads to better results in managing profitable customer retention. |

* Other strategies include improving the determinants of retention.

*Customer retention*

Customer retention is defined as repeat buying in this study. Some of the interviewees agree with this definition. They also added that the amount and frequency of buying has to stay the same if customer is retained. Otherwise, the customer is partially defecting or migrating up.

Some of the retailers and suppliers regard customer retention and loyalty as synonyms. In their opinion, loyal customers also buy regularly. From the suppliers' point of view, brand loyalty is important. Commitment was also emphasized. Customers, who are committed to certain store or brand, can be easily retained. In addition, some of the interviewees said that they are not interested in customer retention, but on customer relationships.

Customer retention is essential for the survival of the company and it must be actively managed. The interviewees agree with this statement. According to some of the interviewees, retention is more important than acquisition of new customers. From the suppliers' point of view, repeat buying is especially important in the case of new products, since repeat purchases are needed to keep the product in the stores. It is expensive for both supplier and retailer to launch a new product. Hence, profitable customer retention is vital. Interestingly, not all the suppliers were familiar with the word customer retention. However, also these interviewees emphasized the importance of customer retention.

The seven determinants of customer retention in the framework are loyalty mechanisms, value, customer expectations vs. delivered quality, product uniqueness and suitability, switching barriers, customer service and ease of purchase. Both retailers and suppliers emphasize the importance of meeting or exceeding customer expectations. If the offering of the company is not right and delivered according to the promise made to the customers, no marketing action will help to keep the customers.

A habit of buying a certain product / patronizing in a certain store was mentioned by the both retailers and suppliers. Especially suppliers emphasize the importance of familiarity of a brand. Many of the interviewees pointed out that the Finnish consumers tend to buy familiar products. This determinant is not directly included in the framework. However, it can be seen as part of ease of purchase, since less decision making and risk is involved when buying familiar products or patronizing in a same store than usually.

Location (proximity), a habit of going in a certain store, the physical appearance of the store, product range, emotional bonds, the personnel of the store, price, quality and service were mentioned by retailers as factors that customers evaluate when deciding where to shop. These are mostly in line with the determinants of the framework. Location and easiness of shopping were emphasized most.

Value was not mentioned in its broader definition (perceived sacrifices vs. perceived benefits) by the retailers, but price-quality ratio was pointed out. In addition, price alone was also seen as an important determinant of retention. Service was pointed out as a way to avoid pure price competition.

Switching barriers as a word were not mentioned by retailers. This is probably because of the low switching cost in grocery retail industry. However, suppliers mentioned lack of close substitutes as a switching barrier. Interestingly, also emotional bonds and the effect of personnel were pointed out by the retailers. These can be seen as switching barriers.

Retailers emphasize product uniqueness and suitability by stating that local assortments designed to meet the needs of the customers are essential. Product ranges vary in different stores based on the buying habits of the local customers. In addition, as noted by Finne (2006), private labels can be used to attract customers.

In the interviews of the suppliers, the significance of the product and brand was emphasized. Quality and price-quality ratio were highlighted more than price. Value from intangible benefits was also brought up. Availability and ease of purchase are essential to keep the customers. These are in line with the framework. However, service was not especially pointed out by the suppliers.

Retailers pointed out marketing actions, such as campaigns and advertising, and loyalty programs as determinants of customer retention. However, these loyalty mechanisms were not seen as important as the other determinants. Suppliers did not mention loyalty mechanisms at all.

As noted before, loyalty mechanisms only work if the basic offering is meeting the needs of the customers. Hence, other retention strategies i.e. affecting the determinants of retention must be used first. Only after the offering is right, marketing actions can be effectively used. The results of the interviews are in line with this. However, loyalty programs and campaigns are seen as important ways to increase customer retention. Suppliers also added communication and brand building to the retention strategies.

*Profitable customer retention*

In the framework, CLTV is used for calculating the value of the customer to the company. Profitability or lifetime value of customers is not researched enough in retail sector. Especially, the allocation of costs to the customers is not properly done. (Finne, 2006) Metrics followed by the retailers include RFM and share of wallet. These metrics are used because of the importance of the purchasing volumes. As noted by Finne (2006), margins of the products sold in grocery stores do not vary considerably and hence, profitability can be enhanced by simply selling more. Thus, customers who visit often and purchase a lot are almost inevitably profitable. Even if these are important metrics in grocery retailing, CLTV should also be used to take the future value of the customers into account.

Suppliers find it difficult to estimate the value of end customers. Hence, only product profitability and profitability of retail chains as customers as calculated. However, suppliers would be interested in profitability or CLTV information if it was available.

As noted before, segment level analysis is appropriate when estimating CLTV. The interviewees agree with this. High level analyses are especially important in grocery retailing in a small country such as Finland, since the business is based on volumes. Decisions made based on CLTV of single customers would not lead to optimal results. As noted by one of the interviewees, CLTV analysis should be used only on strategy level decision making.

CLTV is used as basis for target segment selection in the framework. In retailing, there is nonexistent or limited use of CLTV. Customer profitability analysis is used to some extent, but it is not the main driver of target segment decisions. Instead, segmentation based on demographics or other criteria is used to select the segments. Suppliers do not rely on profitability based segmentation; they use demographics of lifestyle based segments. This in mainly because of the lack of the profitability information about customers. Many of the interviewees noted that decisions should be made more based on customer profitability or CLTV, if it was possible. According to the suppliers, the profitability of products is used in decision making since this information is easily available. Thus, different amounts of resources are allocated to the marketing actions of the products.

According to the framework, only segments with high CLTV would be targeted. The interviewees pointed out that different amount of resources are used to different segments, but the whole customer base must be targeted. Again, this is because of the importance of purchasing volumes.

In the framework, marketing actions (retention strategies) are based on CLTV. CLTV after each possible action is estimated by simulation and the action with highest expected CLTV is chosen. Hence, the action which increases the value of the customers most is seen as the best alternative.

Both retailers and suppliers estimate the short and long term ROI of the marketing action in their decision making. This might lead to different decisions than CLTV based decision making. However, it is difficult to estimate the difference of these metrics since the exact calculation method is not known. It might be that not all of the factors that increase CLTV are taken into account when estimating ROI. Nevertheless, long term ROI is estimated, which indicates that the future value of the customers is taken into account to some extent.

As noted in the theoretical part of the study, customer retention and profitability are linked in three ways: 1) profitability of a single customer is improved, 2) the profitability of the customer portfolio is improved by increasing the amount of profitable customers, and 3) the profitability of marketing actions (retention strategies) is improved. The retailers mentioned cross- and up-selling as a way of enhancing profitable customer retention by improving the profitability of a single customer or customer segment. Suppliers, on the other hand, emphasize enhancing the profitability of a single product.

According to the retailers, another way to increase profitability through customer retention is improving the profitability of marketing actions. Also the suppliers mentioned this. The interviewees also pointed out that the amount of "good" customers should be increased. No resources should be used to keep the "bad" customers; instead, their defection is usually seen as a good thing. Hence, profitability of the whole customer base is increased by adding the amount of profitable customers and at the same time, decreasing the amount of less profitable customers.

In sum, all the parts of the framework were mentioned in the interviews. It seems that there is willingness to manage retention based on CLTV, but there is not enough information and knowledge yet. Most of the interviewees noted that things are going to change soon. Better data warehouses and data mining tools are coming and both retailers and suppliers are becoming better in using customer information. As noted by Kautto (2006), the ones who can utilize customer data best and proactively meet the needs of the customers will survive as a winner in the competition. The knowledge and capabilities of higher top executives are essential in planning and implementing the new way of doing business.

*Partnerships*

In the framework, partnerships are used to improve every part of the process. Collaborative effort between retailers and suppliers leads to better results in managing profitable customer retention. According to the interviewees, partnerships have not brought any added value to customer retention management yet. More collaboration is needed to increase customer retention in a profitable way. Both parties should concentrate on the consumer and manage customer retention together. Especially suppliers feel that collaboration is not deep enough to maximally benefit both parties.

# 8 SUMMARY AND CONCLUSIONS

The aim of this study was to examine how customer retention can be managed profitably and how collaboration between retailer and supplier can improve the process. In the theoretical part, the framework was build based on literature. In the empirical part of the study, the theoretical framework was applied. This Chapter summarizes the findings of the empirical part of the study. In addition, conclusions and possible subjects for future research are discussed.

## 8.1 Summary of the Empirical Section

The empirical study concentrated on the elements of the theoretical framework: value of the customer, customer retention, target segment and marketing action selection, determinants of retention, retention strategies and partnerships. The results from the interviews of the retailers and suppliers were compared to each other and to the theoretical framework.

All of the interviewees agree that customer retention is essential to the survival of the company. The definitions of retention varied to some extent, but repeat buying was mentioned by every interviewee. Customer retention must be carefully managed to ensure the success of the company. Total defection is not the main concern in the grocery retailing industry. It is more relevant to monitor up- and downward migration.

There were some differences between retailers and suppliers. Suppliers concentrate more on retailer-supplier relationship than on end customers. This is natural, since they feel that there is no straight connection to the end customers. However, there is a need for more concentration on the consumer.

Retailers have access to detailed customer data, which enables them to analyze the profitability and lifetime value of customers. Hence, retailers use customer profitability and CLTV more in decision making than suppliers. Target segments and marketing actions are selected to some extent based on CLTV. Suppliers would be interested to use this information if it was available. Compared to the framework, CLTV is not used to the extent it could be. Hence, there is still possibility to improve the profitability of retention strategies.

Loyalty programs and retention campaigns are an important part of customer retention management, but they do not work if the basic expectations of the customers are not met. Product range, service and other determinants of retention must be on an acceptable level before loyalty program or retention strategy can work.

Collaboration between retailers and suppliers vary to great extent. Some of them are already cooperating in customer retention management, while others see that partnerships haven't brought any added value to customer retention management yet. Suppliers seem to be more interested in deepening the partnerships than retailers. In sum, more collaboration is needed to improve the profitability of the whole value chain. However, collaborative partnerships are not relevant to every retailer and supplier. Strategic partnerships are formed with selected partners only. Hence, it is important that both of the parties can show that they can create value to the customer and hence, to the value chain.

## 8.2 Conclusions

The way of managing profitable customer retention introduced in the theoretical section of this study is used to some extent in the case companies. Future orientated thinking seems to be common among the interviewed companies, but it has not led to extensive utilization of CLTV in decision making. Retailers are making more decisions based on customer profitability and CLTV than suppliers. This is because they have better access to data and direct contact to consumers. Suppliers are not making decisions based on CLTV yet, since information is not available. In addition, they feel that they are lacking direct connection to consumers. Thus, retailers as customers are analyzed more as well as the profitability of products. There is a need for information sharing and deeper collaboration to improve the profitability of both retailers and suppliers. In order to identify the customers who bring most value to both parties, collaboration is needed.

Even if the framework does not fit to the way of doing business at the moment, data and tools to improve the operations are available. It will take some time before processes and thinking in the companies are changing, but there seems to be a need for more fact based management of customer retention. Grocery retailing industry in Finland is changing rapidly. Especially the use of technology and customer data will shape the way of doing business in the near future. The ones who can utilize customer data best and hence, create differentiating offers to the customers, will success better in the fierce competition. Since partial defection is biggest threat to customer retention in grocery retailing, migration of CLTV based segments should be carefully monitored and actions should be taken to improve the profitability of the whole customer base.

CLTV as a tool seem to be an appropriate tool only on high level decisions in grocery retailing. Volumes of the purchases are crucial to both retailers and suppliers. Thus, segments to be targeted must be big enough to achieve the minimum amount of purchases. Decisions about the target segment of the whole chain can be done based on CLTV and hence, ensure that the customer base is made of customers with high CLTV. In addition, by linking CLTV and GIS, location decisions can be made. Since proximity is important to the customers, the type of customers patronizing in the store can be affected by choosing the location based on the characteristics of the consumers living nearby. When planning marketing actions, big enough segments must be targeted to ensure actions that have enough effect to the total sales.

It seems that profitable customer retention management is not relevant to all store types. Hard discounters, such as Lidl, which compete purely based on price, would probably not benefit from analyzing CLTV and making decisions based on it. Hard discounters do not usually have loyalty programs. Thus, they do not have data about customers. Hence, concentration to shopping basket analysis is more appropriate. In addition, close partnerships are not common between hard discounters and their suppliers. Thus, collaborative customer relationship management is not applicable.

Profitable customer retention management can be used in retail chains that do not wish to take part in the fierce price competition. Profitability can be enhanced by concentrating on creating value to the right segments. More lasting relationships with customers can be created when the offering is not based on price. Customer data can be used to differentiate the offering to attract customers with high CLTV. In addition, partnerships can be used to create more value to the customers and hence, to retailers and suppliers.

## 8.3 Subjects for Future Research

The method of calculating CLTV was introduced in this study, but it was not tested. A potential topic for future research would be to test different methods of calculating CLTV in grocery retailing. In addition, effectiveness of CLTV in decision making should be analyzed.

Another interesting area of future research is to test the framework in other industries. Managing profitable customer retention should be researched also among other industries, since the results of this study might not be fully generalizable. Other non-contractual settings, such as services (traveling, health services etc.), should be researched to find out how customer retention could be profitably managed. Contractual settings are researched quite much, but more could be done.

In addition to other industries, researching other countries is also a potential topic for future research. Finnish markets have many special characteristics which affect the way of doing business. Profitable customer retention might work better in bigger markets where concentration on certain segments is more appropriate. Grocery retailing is more developed in some countries. Hence, it would be interesting to compare the way of managing customer retention in different kinds of markets.

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**INTERVIEWS**

| | |
|---|---|
| Finne, Sami; Principal, Capgemini Finland | 21.03.2006 |
| Horsti, Aleksi; Development Manager, K-Plus | 13.03.2006 |
| Kautto, Matti; MSc (Econ.) | 16.03.2006 |
| Lantto, Esko; Marketing Manager, Retail Chains, Saarioinen | 27.02.2006 |
| Lindholm, Jarmo; Director, Meal Solutions, Atria | 28.02.2006 |
| Luoto, Kari; Marketing Director, Tradeka | 22.02.2006 |
| Rydenfelt, Susanne; Area Marketing Director, Cloetta Fazer | 15.03.2006 |
| Saikko, Mikko; Development Manager, Tradeka | 16.03.2006 |
| Syväniemi, Antti; Development Manager, K-Plus | 02.03.2006 |
| Toivonen, Petri; Key Account Manager, Valio | 02.03.2006 |
| Virtanen, Paula; Customer Marketing Manager, Vaasan & Vaasan | 21.03.2006 |

## APPENDIX 1: Questionnaire form

**Asiakaspysyvyys**
Miten määrittelisit asiakaspysyvyyden?
Kuinka tärkeää asiakaspysyvyys on yrityksesi kannalta?
Miten asiakaspysyvyyttä seurataan, kuka on asiakas? (Miten asiakkuus syntyy, miten se loppuu)
Miksi asiakkaat pysyvät?

**Asiakaskannattavuus**
Millainen asiakas on kannattava / mistä kannattavuus muodostuu?
Miten asiakkaiden kannattavuutta havainnoidaan?
Millaisia laskuperusteita käytetään?
Lasketaanko kannattavuutta vai asiakkaan elinkaaren arvoa?
Tehdäänkö asiakaskannattavuuden perusteella päätöksiä esimerkiksi markkinoinnin suhteen?
Miten kannattavuus liittyy asiakaspysyvyyteen?

**Kannattavan asiakaspysyvyyden hallitseminen**
Miten asiakaspysyvyyttä voitaisiin lisätä?
Yritetäänkö asiakaspysyvyyttä lisätä?
Millä keinoin?
Millaisia keinot tulevaisuudessa voitaisiin käyttää?

Miten valitaan mitä keinoja käytetään asiakaspysyvyyden lisäämiseen?
Arvioidaanko eri keinojen kannattavuutta (ennen ja /tai jälkeen)?
Miten kannattavuus lasketaan?
Miten suunnitellaan?

Pyritäänkö koko asiakaskannan pysyvyyttä lisätä vai vain tiettyjen asiakkaiden / segmenttien?
Jos resurssit kohdistetaan vain tiettyihin asiakkaisiin / segmentteihin, miten nämä asiakkaat / segmentit valitaan?

Miten asiakaspysyvyyden lisäämiseen käytettävä budjetti määritellään?
Vaihteleeko eri asiakkaisiin käytettävät resurssit?

**Partnereiden merkitys**
Mikä on partnereiden merkitys liiketoiminnalle?
Mikä on partnereiden merkitys asiakaspysyvyyden hallinnassa?
Missä määrin yhteistyötä tehdään nykyään?
Onko yhteisiä tavoitteita / toimintatapoja?
Miten tietoa jaetaan? Mitä tietoja toiselta osapuolelta tarvitaan?
Miten tilanne tulee muuttumaan tulevaisuudessa?